TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1960

No. 288

AMERICAN AUTOMOBILE ASSOCIATION,
PETITIONER,

vs.

UNITED STATES.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

PETITION FOR CERTIORARI FILED AUGUST 2, 1960

CERTIORARI GRANTED OCTOBER 10, 1960

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1960

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[fol. 1]

IN THE UNITED STATES COURT OF CLAIMS

Docket No. 311-58

AMERICAN AUTOMOBILE ASSOCIATION, Plaintiff,

v.

UNITED STATES OF AMERICA, Defendant.

PETITION—Filed July 8, 1958

Plaintiff brings this action to recover from the United States of America the sum of $207,994.56 with interest according to law, representing Federal income taxes and interest collected illegally by the defendant from the plaintiff for the calendar years 1952 and 1953, and in support of its action alleges as follows:

(1) Plaintiff is a corporation with principal office at 1712 G Street, Northwest, Washington, D. C. Plaintiff was incorporated in the year 1910 under the laws of the State of Connecticut, and was organized and is operated as a non-profit, non-stock, membership corporation.

(2) Plaintiff is a national organization which renders services to affiliated local automobile clubs and their mem-
[fol. 2] bers and performs services of a public nature in fields relating to motoring and travel.

(3) In addition to the activities described in paragraph (2) above, plaintiff operates directly, as divisions, the following local automobile clubs:

District of Columbia Division of AAA (Metropolitan area, Washington, D. C.)
Louisiana Division of AAA (entire state)
Massachusetts Division of AAA (part of state)
New Hampshire Division of AAA (entire state)
New Mexico Division of AAA (entire state)

North Florida Division of AAA }
South Florida Division of AAA } (part of state)
Texas Division of AAA (part of state)
Wisconsin Division of AAA (entire state)
Wyoming Division of AAA (entire state)

(4) A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs described in paragraph (3) and operated as divisions of plaintiff. Plaintiff is obligated to provide services for such members over the twelve-month period following payment of dues, which services include emergency road service, travel information, accident insurance, bail bond, and similar items.

(5) Plaintiff, commencing with the calendar year 1943, has been required to file Federal income tax returns and to pay Federal income taxes on its net income. Its Federal income tax returns are filed with the District Director of Internal Revenue, Baltimore, Maryland. The plaintiff's taxable year is the calendar year.

(6) Plaintiff employs the accrual method of accounting in keeping its books and records and in filing its Federal income tax returns.

(7) Under the method of accounting employed by plaintiff throughout the years in issue dues prepaid for one year [fol. 3] in advance by a member of an automobile club operated as a division of the AAA were reflected in plaintiff's income ratably over the twelve-month period of the membership covered by the dues rather than entirely in the calendar year in which the dues were received. That portion of the prepaid dues of a member not reflected in income in the year of receipt was credited to an account called "Deferred Revenue—Membership Dues" and reflected in income during the following calendar year. Similarly, prepaid commission expenses and prepaid accident insurance costs paid by plaintiff in behalf of a member of its divisions were not deducted from income entirely in the calendar year paid or incurred but were spread ratably over the

twelve-month period of the membership. That portion of prepaid commissions and prepaid accident insurance costs not deducted from income in the year paid or incurred was charged to an account called "Prepaid Membership Costs" and deducted from income during the following calendar year.

(8) The method of accounting employed by plaintiff as described in (7) above, was adopted upon the advice of qualified members of the accounting profession many years prior to 1943, when plaintiff was first required to pay Federal income taxes. This method of accounting has been regularly used by plaintiff, was accepted by the Commissioner of Internal Revenue for the calendar years 1943 through 1952, and is in conformity with the provisions of sections 41 and 42(a) of the Internal Revenue Code of 1939 and sections 446(a), 446(c)(2) and 451 of the Internal Revenue Code of 1954.

(9) The method of accounting employed by plaintiff in keeping its books and records and in filing its Federal income tax returns clearly reflects its net income or loss for a calendar year.

(10) The net income of plaintiff for the calendar year 1952 computed in accordance with the method of account-[fol. 4] ing employed in keeping its books and records and prior to the net operating loss carryback deduction from 1954, was $154,411.11.

(11) The net income of plaintiff for the calendar year 1953 computed in accordance with the method of accounting employed by plaintiff in keeping its books and records and prior to the net operating loss carryback deduction from 1954, was $353,279.09.

(12) During the calendar year 1954 plaintiff sustained a net operating loss of $289,967.67, computed in accordance with the method of accounting employed by plaintiff in keeping its books and records. Under section 172 of the Internal Revenue Code of 1954 plaintiff is entitled to a net operating loss carryback deduction from the calendar year 1954 to the calendar year 1952 in the amount of $154,411.11;

and a net operating loss carryback deduction from the calendar year 1954 to the calendar year 1953 in the amount of $135,556.56. The net operating loss carryback deduction from 1954 eliminates all 1952 taxable income, and reduces the plaintiff's 1953 taxable income from $353,279.09 to $217,722.53.

(13) Upon audit of its tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue reduced the 1954 operating loss of plaintiff from $289,967.67 to $14,412.49. This reduced the net operating loss carryback deduction from 1954 to 1952 to $14,412.49 and eliminated any net operating loss carryback deduction to 1953. In addition, the Commissioner increased the net income of plaintiff for 1953 by $128,278.50.

(14) The reduction in the amount of the net operating loss sustained by plaintiff during the calendar year 1954 and the increase in the net income of plaintiff for the calendar year 1953 as determined by the Commissioner were caused by the fact that the Commissioner forced plaintiff to change its method of accounting as described [fol. 5] in paragraph (7) of this petition, so as to report all prepaid dues as taxable income in the calendar year of receipt, whether or not earned in that year, and so as to deduct all prepaid membership expenses in the calendar year paid, irrespective of whether such expenses were properly allocable to that year under the accounting method regularly used by plaintiff.

(15) The action of the Commissioner of Internal Revenue in changing plaintiff's method of accounting as described above, was without authority and in error.

(16) As the result of the adjustments described heretofore, the Commissioner of Internal Revenue on May 15, 1956 asserted an income tax deficiency against plaintiff in the amount of $58,083.58 for the calendar year 1952 and in the amount of $137,907.48 for the calendar year 1953.

(17) On May 23, 1956 plaintiff paid to the District Director of Internal Revenue, Baltimore, Maryland, additional 1952 income taxes in the amount of $58,083.58 plus

interest thereon in the amount of $2,019.37, and additional 1953 income taxes in the amount of $137,907.48 plus interest thereon in the amount of $10,789.77.

(18) On May 9, 1958 plaintiff filed with the District Director of Internal Revenue, Baltimore, Maryland, a claim for refund of income taxes and interest for the calendar year 1952 in the amount of $60,102.95 and for the calendar year 1953 in the amount of $147,891.61, based upon the four grounds described hereinafter:

First, that plaintiff's method of accounting clearly reflected its net income or loss, that the Commissioner's method of accounting did not, and that the Commissioner had no power or authority to force plaintiff to change from an accurate to an inaccurate method of accounting as described heretofore.

Second, plaintiff's method of accounting was designed to match the income derived from a member of its divisions [fol. 6] with the expense of serving such member in order to determine whether a profit was derived from a membership. If the prorata allocation of prepaid dues on a monthly basis over the period of a membership should be held to be artificial or held not to reflect income clearly, plaintiff claimed in the alternate the refunds to which it was entitled based upon a method of accounting which spreads dues over the twelve-month period of a membership in proportion to the average cost per month of serving a member determined by reference to the experience of plaintiff during the five preceding years. On such basis the 1954 operating loss would be $282,782.12, the 1953 net income before the carryback deduction would be $358,993.93, and the income tax refunds to which plaintiff was entitled would be $58,083.58 for 1952 and $130,486.03 for 1953 together with interest according to law.

Third, the imposition of an income tax computed in the manner forced upon plaintiff by the Commissioner during the years in issue was unconstitutional because an income tax was in effect being imposed upon gross income rather than net income.

Fourth, the method of accounting forced upon plaintiff by the Commissioner during the years in issue did not clearly reflect its net income or loss. Plaintiff is entitled to have its net income or loss and its Federal income tax liability during such years recomputed by reference to any method of accounting which does clearly reflect its net income or loss.

(19) The Commissioner of Internal Revenue disallowed said claims for refund on the 1st day of July, 1958.

(20) The Commissioner of Internal Revenue erred in failing to approve said claims for refund on each and all of the four grounds described above.

(21) No action on this claim other than that described heretofore has been taken by plaintiff before the Congress [fol. 7] of the United States or before any department of the government.

(22) Plaintiff is and always has been the sole and absolute owner of the claims described herein and no transfer or assignment of said claims or any part thereof has been made by plaintiff.

Wherefore, plaintiff prays for judgment against the United States of America in the amount of $207,994.56 together with interest thereon according to law.

Fleming Bomar, Attorney for Plaintiff.

Ivins, Phillips & Barker, 306 Southern Building, Washington 5, D. C.

[fol. 8]

IN THE UNITED STATES COURT OF CLAIMS

[Title omitted]

ANSWER—Filed September 5, 1958

The defendant, United States of America, by its attorney, Charles K. Rice, Assistant Attorney General, answering the allegations in plaintiff's petition herein:

I

Defendant denies the allegations contained in the introductory paragraph, except that defendant admits that in this action plaintiff seeks to recover from the United States of America the sum of $207,994.56.

II

Further answering the petition, defendant—

1. Admits the allegations of Paragraph 1, except that defendant denies that plaintiff is a non-profit corporation.

2. Admits the allegations of Paragraph 2.

[fol. 9] 3. Admits the allegations of Paragraph 3.

4. Admits the allegations of Paragraph 4.

5. Admits the allegations of Paragraph 5.

6. Admits the allegations of Paragraph 6.

7. Admits the allegations of Paragraph 7.

8. Denies the allegations of Paragraph 8, except that defendant admits that the method of accounting referred to therein was regularly used by plaintiff.

9. Denies the allegations of Paragraph 9.

10. Denies the allegations of Paragraph 10, except that defendant admits that the net income reported by plaintiff in its income tax return for the calendar year 1952 com-

puted in accordance with its method of accounting was $152,975.31.

11. Denies the allegations of Paragraph 11, except that defendant admits that the net income reported by plaintiff in its income tax return for the calendar year 1953 computed in accordance with its method of accounting was $352,125.84.

12. Denies the allegations of Paragraph 12.

13. Denies the allegations of Paragraph 13, except that defendant admits that upon audit of plaintiff's returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue reduced the 1954 operating loss claimed by plaintiff in the amount of $290,186.04 to $14,412.49 and that this reduction in the net operating loss claimed eliminated any net operating loss carryback to 1953. Defendant further admits that in addition, the Commissioner increased the net income of plaintiff for 1953 by $128,278.50.

14. Denies the allegations of Paragraph 14, except that defendant admits that the reduction in the amount of the net operating loss claimed by plaintiff for the year 1954 [fol. 10] and the increase in the net income of plaintiff for the calendar year 1953 as determined by the Commissioner were caused by the fact that the Commissioner changed plaintiff's method of accounting as described in Paragraph 7 of this petition so as to include all prepaid dues as taxable income in the calendar year of receipt. Defendant further admits that the Commissioner allowed as deductions from plaintiff's taxable income as reported, all membership expenses in the calendar year in which paid.

15. Denies the allegations of Paragraph 15.

16. Admits the allegations of Paragraph 16.

17. Admits the allegations of Paragraph 17, except that defendant denies that the payments referred to therein were made on May 23, 1956 and alleges that the payment of additional taxes and interest for the year 1952 was made on May 28, 1956, and that the payment of addi-

tional taxes and interest for the year 1953 was made on May 25, 1956.

18. Denies the allegations of Paragraph 18, except that defendant admits that on May 10, 1958, plaintiff filed with the District Director of Internal Revenue, Baltimore, Maryland, claims for refund of income taxes and interest for the calendar year 1952 in the amount of $60,102.95 and for the calendar year 1953 in the amount of $147,891.61. Defendant further admits that such claims were based, in addition to others, on the four grounds set forth in Paragraph 18 but defendant denies all allegations set forth in such grounds and all other substantive allegations contained in such claims for refund unless otherwise herein specifically admitted.

19. Admits the allegations in Paragraph 19.

20. Denies the allegations in Paragraph 20.

[fol. 11] 21. Denies the allegations of Paragraph 21 for lack of information sufficient to form a belief as to the truth thereof.

22. Denies the allegations of Paragraph 22 for lack of information sufficient to form a belief as to the truth thereof.

Wherefore, defendant, having fully answered plaintiff's petition, prays that it take nothing in this suit; that plaintiff's petition be dismissed, and that defendant be allowed its cost herein.

Charles K. Rice, Assistant Attorney General.

William T. Kane, Attorney.

[fol. 12]

IN THE UNITED STATES COURT OF CLAIMS

No. 311-58

[Title omitted]

REPORT OF COMMISSIONER—Filed July 16, 1959

To the Honorable the Chief Judge and Associate Judges of the United States Court of Claims:

Pursuant to the order of reference in the above-entitled case, the undersigned Commissioner makes the following report of his findings of fact:

1. Plaintiff is a corporation with its principal office at 1712 G Street, Northwest, Washington, D.C. Plaintiff was incorporated in the year 1910 under the laws of the State of Connecticut and was organized and is operated as a non-stock, membership corporation.

2. Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel.

3. In addition to the activities described in paragraph two above, plaintiff operates directly, as divisions, the following local automobile clubs:

District of Columbia Division of AAA
(Metropolitan area, Washington, D. C.)
Louisiana Division of AAA (entire state)
Massachusetts Division of AAA (part of state)
New Hampshire Division of AAA (entire state)
New Mexico Division of AAA (entire state)
North Florida Division of AAA } (part of state)
South Florida Division of AAA }
Texas Division of AAA (part of state)
Wisconsin Division of AAA (entire state)
Wyoming Division of AAA (entire state)

[fol. 13] 4. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs described in paragraph three and operated as divisions of plaintiff. Plaintiff is obligated to provide services for such members over the 12-month period following payment of dues. The services provided by plaintiff for the members of its divisions during the years in issue, although tending to be parallel, were not completely uniform and included the following: (a) A complete travel service which included trip planning, tour books, accommodation directories, maps and recommended routes. (b) Emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs. The road service was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions. (c) Bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen. (d) Personal automobile accident insurance which included hospitalization, personal injury and death benefits on a sliding scale in the event of a motoring accident. The plaintiff contracted for the insurance on a group basis and paid the premiums on the group policies. (e) A theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car. In addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

5. In order to make available and provide for the members of its divisions the services which plaintiff contracted to provide, plaintiff during the years in issue owned or rented offices in 39 to 41 different geographical locations and had on its divisions' payroll 495 employees in December 1953 and 603 employees in December 1954.

6. Plaintiff, commencing with the calendar year 1943, has been required to file Federal income tax returns and to pay Federal income taxes on its net income. Its Federal income tax returns are filed with the District Director of

Internal Revenue, Baltimore, Maryland. The plaintiff's taxable year is the calendar year.

[fol. 14] 7. Plaintiff employs the accrual method of accounting in keeping its books and records and in filing its Federal income tax returns.

8. Plaintiff, within the time prescribed by law, filed Federal income tax returns with the District Director of Internal Revenue, Baltimore, Maryland, for the calendar years 1952, 1953 and 1954. The 1952 return reported a net income of $152,975.51, the 1953 return reported a net income of $352,125.84, and the 1954 return reported a net operating loss in the amount of $290,186.04.

9. Upon audit of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue made several minor adjustments which are not in issue in this proceeding, the net effect of which was to increase plaintiff's 1952 net income to $154,411.11, to increase plaintiff's 1953 net income to $353,279.09, and to reduce plaintiff's 1954 net operating loss to $289,967.67.

10. Plaintiff claimed that as a result of its 1954 net operating loss in the amount of $289,967.67, it was entitled to a net operating loss carryback deduction to 1952 in the amount of $154,411.11, and a net operating loss carryback deduction to 1953 in the amount of $135,556.56.

11. Upon audit of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue also determined not to recognize the method of accounting employed by plaintiff in computing its income derived from prepaid dues collected from members of its divisions during the calendar years 1953 and 1954, which is the issue in this proceeding. The net effect of such determination was to increase plaintiff's 1953 net income from $353,279.09 to $481,557.59 and to reduce plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49, with the further result that the Commissioner reduced plaintiff's net operating loss carryback deduction

from $154,411.11 in 1954 to $14,412.49 in 1952 and eliminated entirely any net operating loss carryback deduction from 1954 to 1953.

12. The Commissioner of Internal Revenue determined the increase of plaintiff's income for 1953 by $128,278.50 [fol. 15] and the reduction of plaintiff's loss for 1954 by $275,555.15 was in the following manner:

	1953 Adjustments	1954 Adjustments
Reserve for unearned and deferred income Dec. 31 of current year	$1,756,485.46	$2,039,264.43
Less reserve for unearned and deferred income Dec. 31 of prior year	1,562,042.23	1,756,485.46
Difference	194,443.23	282,778.97
Less		
Prepaid commissions:		
Dec. 31 of current year	398,482.36	405,706.15
Dec. 31 of prior year	332,317.63	398,482.36
Difference	66,164.73	7,223.79
Net additional income determined for the current year	128,278.50	275,555.18

All of the foregoing items are reflected in the plaintiff's balance sheets as of December 31 for the years involved, which were filed with its income tax returns for 1953 and 1954. The liabilities contain the account UNEARNED AND DEFERRED INCOME, and the assets contain the account PREPAID COMMISSIONS, but the latter account is not involved in the items labeled prepaid commissions in the above tabulation. The deduction items employed by the Commissioner of the Internal Revenue Service represent plaintiff's asset account for prepaid membership costs. The plaintiff's assets for 1954 do not reflect any amount for prepaid membership

costs, but its liabilities for unearned and deferred income reflect the approximate net difference between $2,039,264.43 and $405,706.15 in its 1954 balance sheet..

13. As a result of the adjustments described heretofore, the Commissioner of Internal Revenue on May 15, 1956, asserted an income tax deficiency against plaintiff in the amount of $58,083.58 for the calendar year 1952, and in the amount of $137,907.48 for the calendar year 1953. These deficiencies in tax, plus interest of $2,019.37 for the year 1952 and $10,789.77 for the year 1953, were paid by plaintiff on May 25, 1956, and May 28, 1956.

[fol. 16] 14. On May 10, 1958, plaintiff filed timely claims for refund for each of the years in suit, which claims for refund raised the issues upon which plaintiff now seeks recovery in this action. On July 1, 1958, the Commissioner of Internal Revenue notified plaintiff by registered letter that its claims for refund had been denied.

15. Plaintiff, being a nonstock, membership corporation, obtained substantially all of the funds necessary to carry on the operation of its divisions by advances from its members, i.e., dues prepaid for one year in advance in consideration of services to be rendered by plaintiff over the ensuing 12-month period.

Plaintiff's balance sheets filed with its 1953 and 1954 income tax returns reflect cash on hand December 31, 1953, of $1,941,723.88 and dues paid in advance of $1,756,485.46. The excess of $185,238.42 would represent cash received from other sources. However, on December 31, 1954, the dues collected in advance and reported in plaintiff's balance sheet at $1,634,840.81 exceeded the cash on hand of $1,502,478.97 by the sum of $132,361.84.

16. Under the method of accounting employed by plaintiff during the years in issue, advance dues collected from members of its divisions were not regarded entirely as income for accounting purposes in the calendar year of receipt, but instead advance dues were recognized and treated as income ratably over the 12-month period during which plaintiff was obligated to render services to such

members whether or not such period extended beyond the close of plaintiff's taxable year.

As of December 31 of each taxable year, the proportion of advance dues, collected within the year applicable to membership contracts extending beyond the close of the taxable year and for which services had not yet been rendered or made available, was considered and recorded as a liability of plaintiff and was reflected on plaintiff's balance sheet with its tax return as a liability.

Expenses which plaintiff considered to fall within the category of prepaid membership costs, i.e., salesmen's commissions, and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were [fol. 17] not deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that advance dues were recognized as income.

17. During the calendar years 1953 and 1954, plaintiff recorded on its books and records, by months, the following amounts of prepaid or advance dues collected from members of its divisions:

	1953	1954
January	$257,698.02	$290,764.23
February	236,610.67	284,319.95
March	282,430.08	351,697.47
April	296,647.02	329,066.99
May	328,191.75	382,385.38
June	378,716.30	451,260.81
July	386,150.87	435,832.93
August	336,269.66	395,009.70
September	275,235.54	260,950.54
October	268,661.48	309,543.51
November	219,278.02	279,144.44
December	265,289.26	308,553.22
	3,531,178.67	4,078,529.17

This money was deposited in plaintiff's bank accounts with no restrictions as to its use for any of its corporate

purposes. It was, in fact, prepaid financing by the members for the corporation's operating funds, including the cost of services to be performed during the following 12-month period of membership, as reported in finding 15 herein.

Section 4 of the bylaws of the American Automobile Association specifically provided for the use of funds and reads as follows:

> SECTION 4. (*Use of Funds*) This corporation shall use its funds only to accomplish the objects and purposes specified in Section 3, and no part of said funds shall inure, or be distributed, to the members of this corporation. On dissolution the funds of the corporation shall be distributed to one or more regularly organized charitable organizations to be selected by the Board of Directors.

18. Prepaid dues were true liabilities of the plaintiff at the time they were collected. Under the accounting system employed by the plaintiff from 1931 through 1953 advance dues collected from members who joined in the month of [fol. 18] January were recognized as income in January to the extent of 1/24 of such collections, on the assumption that the average or mean date would be the middle of the month. Thereafter, 1/12 of prepaid collections for January was transferred or allocated to income for each of the following 11 months, and 1/24 of January collections remained a liability on December 31 and was transferred and recognized as income for January of the following year.

Prepaid dues for each month of the calendar year were treated in the same manner, that is, 1/24 of such collections was transferred and recognized as income in the current month when collections were made, 1/12 of such collections during the following 11 months and 1/24 thereof in the last month when membership expired. The monthly collections of prepaid dues during a calendar year which were recognized and transferred to income during the current year and the portion thereof remaining in the liability account at the end of the year, which was entitled DEFERRED REVENUE MEMBERSHIP DUES, UNEARNED AND DEFERRED INCOME OR some similar title, appear in the following tabulation:

	Portion Treated as Income for the Current Year	Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year
January	23/24	1/24
February	21/24	3/24
March	19/24	5/24
April	17/24	7/24
May	15/24	9/24
June	13/24	11/24
July	11/24	13/24
August	9/24	15/24
September	7/24	17/24
October	5/24	19/24
November	3/24	21/24
December	1/24	23/24

The allocation of prepaid dues each month facilitated the preparation of monthly statements of income and expenses. Had monthly collections been equal for each month during a year, the amount recognized as income during the current year and the amount remaining as a liability at the end of the year would have been equal under the foregoing apportionments.

[fol. 19] 19. Under the method of accounting employed by plaintiff, the proportion existing between dues collected from members of its divisions within a calendar year, which dues were recognized as income during such year, and the proportion of such dues regarded as a liability at the end of such year was as follows for the calendar years 1949 through 1954:

	Portion Recognized as Income During the Year Collected	Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year
1949	49.9%	50.1%
1950	50.0%	50.0%
1951	50.2%	49.8%
1952	50.6%	49.4%
1953	50.3%	49.7%
1954	50.0%	50.0%

20. Commencing in 1954, in order to simplify much internal detail, the plaintiff changed its procedure in the monthly accounting for prepaid dues by the assignment of 50 percent to income for the current year and 50 percent as a liability which matured as income for the following year.

Plaintiff also adjusted certain inconsistencies in its prepaid expense account in 1954. Some division managers were paid a straight salary, whereas others were paid a nominal salary plus incentive commissions based upon the number of members within the division. These incentive commissions had been previously charged to the prepaid expense account and prorated over membership periods, whereas such incentive pay was actually a part of the manager's compensation. It was treated as current expense in 1954 and thereafter. Also, guaranteed commissions to new salesmen for a certain limited period had been included with commissions earned on subscriptions obtained, as prepaid expense, and beginning in 1954 such unearned guaranteed payments were charged to current expenses.

The plaintiff continued the apportionment of prepaid dues collected and prepaid expenses for commissions and insurance over the period of membership as it had done previously. The basic method of accounting employed by plaintiff in 1954 was consistent with that employed by plaintiff in 1953 and prior years.

[fol. 20] 21. The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,337,813.44, representing $1,562,042.23 of prepaid dues collected in 1952 but not recognized as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,407.46 of advance dues collected in 1953 but not recognized as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year.

22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and was used both before and after plaintiff was required to pay Federal income taxes. The method of

accounting employed by plaintiff during the years in issue is in accord with generally accepted accounting principles and practices and is customarily and generally employed in the motor club field.

The Internal Revenue Service did not question the method of accounting employed by plaintiff in computing its net income until the calendar year 1954, at which time deficiencies were proposed for the calendar years 1950, 1951 and 1952, but plaintiff was not required to pay those deficiencies by reason of a compromise settlement.

23. Under generally accepted accounting principles a distinction is made between a financing transaction and a revenue or income transaction. Funds received in a revenue or income transaction are reflected in the profit and loss statement of a taxpayer as gross income. This is not true in the case of funds received in a financing transaction. They are reflected in the balance sheet as liabilities.

Financing transactions involve ways and means of raising funds for business operations and may be grouped under three general types: (a) funds obtained from shareholders in exchange for stock; (b) funds obtained from banks or other lenders on notes, bonds or other evidence of indebtedness; and (c) funds obtained by advances from customers or members on open accounts, receipts or certifi-
[fol. 21] cates of membership for future delivery of goods or services to be rendered in the future.

Funds representing advances from customers or members of an organization are not income at the time they are received but constitute a liability until such time as goods are delivered or services are rendered or made available in accordance with the advance payment agreement. It is an undisputed principle of accounting that no revenue or income can emerge until goods are delivered or until services are rendered.

Upon the prepayment of annual dues a member of the plaintiff corporation acquired a right to receive certain materials, information and services provided in the membership agreement over a 12-month period. Plaintiff's liability to such member cannot be completely discharged until the expiration of the membership period. Under generally accepted accounting principles, it is realistic and reason-

able to recognize and transfer to gross income such prepaid dues ratably over the period of membership.

24. The determination of additional income by the Commissioner of the Internal Revenue Service for the taxable years involved herein was made by including as income the advance payment of dues covering membership benefit periods in the following year and excluding those payments received in the prior year that covered membership benefit periods in the current year. This application of the receipt of funds as income is contrary to generally accepted accounting principles and practices.

By taking into income for the current year the plaintiff's liability for servicing membership periods in the following year, the amount of such receipts would be reflected in the plaintiff's surplus account at the end of the current year. The plaintiff's balance sheet as of December 31, 1953, filed with its tax returns for 1953 and 1954 reflecting the items involved, is compared with the balance sheet which would result from the adjustments by the Commissioner of the Internal Revenue Service in the following table:

[fol. 22]

	Balance Sheet on December 31, 1953	
	(a) Reported by Plaintiff	(b) Reflecting the Adjustments by the Commissioner of IRS
ASSETS:		
Cash	$1,941,723.88	$1,941,723.88
Prepaid membership cost	398,482.36	.....
Prepaid commissions	177,079.51	177,079.51
All other accounts, net	2,834,525.72	2,834,525.72
Total assets	5,351,811.47	4,953,329.11
LIABILITIES:		
Unearned and deferred income	1,756,485.46	.....
All other liabilities	1,063,462.99	1,063,462.99
Total liabilities	2,819,948.45	1,063,462.99
SURPLUS	2,531,863.02	3,889,866.12

The above statement (b), embodying the adjustments by the Commissioner of the Internal Revenue Service, reflects an overstatement of surplus for 1953 of $1,358,003.10, or approximately 54 percent in excess of the true surplus.

By applying similar adjustments to plaintiff's balance sheet as of December 31, 1954, the surplus would be increased and overstated by $1,634,840.81, or approximately 99 percent, and would omit plaintiff's liability to members for a similar amount.

A balance sheet as of any given date represents an inventory of cash and accounting evaluations of all other asset accounts and liability accounts of an individual or firm on the date designated, and is prepared for the purpose of reflecting the net worth and financial responsibility of such firm or individual.

The evidence establishes that reputable members of the accounting profession would not certify to the accuracy of the income statements and the balance sheets reflecting the adjustments by the Commissioner of the Internal Revenue Service.[1]

[fol. 23] 25. The defendant contends that the sole issue is whether the Commissioner of Internal Revenue erred in refusing to allow plaintiff to defer a portion of income actually received, without any restriction as to its use, from the year in which it was received to the following year when services might have to be performed under the membership contracts.

The advance payment on a service contract, or any other type of contract, does not constitute income or revenue to the recipient, although the acceptance thereof creates a lia-

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[1] Defendant offered no testimony. Plaintiff's testimony consisted of that of its staff auditors supplemented by outstanding certified public accountants testifying as experts who were, also, either familiar with plaintiff's problem or had some direct association with it and whose qualifications were not challenged. They were: *Dr. Wm. A. Paton*, for 44 years a professor of accounting and economics at the University of Michigan and an author and consultant on accounting. *George E. Baker*, Washington, D.C., resident partner of Ernst and Ernst, Certified Public Accountants. *Herbert T. McAuly*, a general and managing partner of Ernst and Ernst. *S. Alexander Bell*, partner in Peat, Marwick, Mitchell & Co., largest firm of Certified Public Accountants in the world.

bility to perform. Under generally accepted accounting principles, the accounting for the funds received in advance must be recorded as a liability of the recipient. The plaintiff did this consistently since 1931. These membership contracts entitled the members to receive membership services over a period of 12 months from the date of subscription and acceptance. The plaintiff's gross income from dues was measured by collections for the period memberships were in effect during the current year. This included pro rata amounts of prepaid dues collected in the prior year covering membership periods that extended into the current year, but excluded prepaid dues collected in the current year for membership periods that extended into the following year. The membership service costs and other operating expenses paid or incurred during the current year were then deducted from such gross income for its determination of net income.

The method of accounting employed by plaintiff was in accordance with accepted accounting principles. The assignment and transfer of funds from the prepaid dues account to revenue or gross income measured over the period of the membership contracts is found to be the most realistic method for properly recording gross income from dues.

26. The restriction of funds represented by prepaid dues was not required or intended by the plaintiff's members. On the contrary, the receipt of prepaid dues from members constituted the principal source of plaintiff's operating funds as heretofore found. Funds from other sources, such as sales of publications, materials and supplies, advertising, etc., were normally received only after the costs and expenses were incurred in producing such revenues.
[fol. 24] There is no evidence that membership contracts, or certificates issued by plaintiff to its members, provided any restriction in the use of funds received by plaintiff for dues paid in advance. Plaintiff's financial responsibility is not questioned.

27. The plaintiff prepared and submitted tabulations of the aggregate costs incurred by all of its divisions in servicing all members thereof for each month of each year

from 1948 through 1954. These tabulations were received as plaintiff's exhibits 2 through 7, inclusive.

Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed.

28. The proportions of prepaid dues transferred and assigned to gross income by the plaintiff on a pro rata monthly time basis are compared with the proportion of assignments under the average monthly cost bases for servicing memberships in the following table:

	Plaintiff's Pro Rata Method as Reported	Average Monthly Costs for Current Year	Average Monthly Costs over Prior 5-year Period
1953			
Apportioned to Gross Income during current year	50.3%	49.8%	50.4%
Deferred to the Following Year (reported as a liability at the end of the current year)	49.7%	50.2%	49.6%
1954			
Apportioned to Gross Income during the current year	50.0%	48.8%	51.0%
Deferred to the following year (reported as a liability at the end of the current year)	50.0%	51.2%	49.0%

29. The recognition, assignment and transfer of dues collected in advance to gross income on the basis of actual costs of servicing members is feasible under the accrual [fol. 25] method of accounting, particularly in testing the results of prorating such collections on a time basis. It is not as practicable as the assignment of prepaid dues on a pro rata monthly basis because the current costs incurred must first be determined. The employment of a prior year's monthly costs or a composite of monthly costs for five prior years might not be as accurate as the method actually employed by plaintiff because of a constant increase in membership reflected over the years or by abnormal costs of servicing members during one or more of such prior years.

When members paid their annual membership dues they became entitled to membership services over a period of 12 months, notwithstanding any variations in costs to the plaintiff in furnishing the services that might be required. When plaintiff accepted such dues it became obligated to perform the services to which members were entitled and might require over the membership period without regard to any variations or fluctuations in costs in furnishing such services from month to month over the membership period.

On the evidence presented, the recognition and assignment of prepaid dues ratably over the period of membership is found to be the most realistic and practical method of accounting for gross income from membership dues.

30. The plaintiff's membership for all divisions reflects a constant increase from month to month during 1953 and 1954. The minimum number of memberships in effect in 1953 was 220,435 in January and the maximum was 246,856 in December of that year. The minimum number of memberships in effect in 1954 was 249,805 in January and the maximum was 295,889 in December of that year. The average cost to plaintiff of servicing a member during the calendar year 1953 was $14.50 and the average cost for 1954 was $14.72.

31. The plaintiff's liability for servicing members whose membership continued beyond the current year when dues were paid was not a "contingent" liability. It was a true liability and the costs were substantially in proportion to

membership from year to year with reasonable constancy from month to month. The plaintiff's actual costs of ser- [fol. 26] vicing all members from 1948 to 1954 are set out in the following tabulation:

1948	$1,587,794.87
1949	1,698,144.27
1950	2,012,466.23
1951	2,614,396.96
1952	3,109,068.21
1953	3,377,389.91
1954	3,991,068.00

32. The actual average monthly cost per membership in effect during 1953 and 1954 and the percentage of the total annual cost per member is reported in the following tabulation, with the percentage of the total monthly costs to the total costs for the preceding five-year period:

	1953			1954		
	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period	Average monthly cost per member		Percent of monthly costs to total over prior 5 year period
Month	Amount	Percent of cost for year		Amount	Percent of cost for year	
January	$1.12	7.71	7.48	$1.12	7.62	7.46
February	1.10	7.57	7.47	1.27	8.62	7.34
March	1.24	8.52	8.54	1.37	9.27	8.44
April	1.32	9.15	8.85	1.24	8.41	8.82
May	1.28	8.84	8.97	1.35	9.18	8.83
June	1.32	9.12	9.03	1.41	9.56	9.07
July	1.35	9.28	8.90	1.34	9.12	8.93
August	1.23	8.52	8.58	1.24	8.41	8.67
September	1.19	8.22	8.15	1.20	8.16	8.26
October	1.19	8.19	8.20	1.17	7.95	8.42
November	1.06	7.29	7.56	1.10	7.49	7.65
December	1.10	7.59	8.29	.91	6.21	8.11
Total	14.50	100.00	100.00	14.72	100.00	100.00

The foregoing tabulation reflects the actual average cost to plaintiff in each month of the years involved for each member whose membership continued in effect. The difference between the costs incurred for servicing member-

ships that continued from the prior year and the membership fees collected in the prior year, but remaining as a liability of the plaintiff at the end of the year and transferred to gross income in the current year, would represent the net income in the current year applicable to such memberships.

33. The plaintiff's liability to members for that portion of their memberships which extended beyond the current [fol. 27] year in which plaintiff collected the dues in advance is not gross income from membership dues because it was paid and received for a later year. Neither can it be net income in the year when the dues were received because the cost of servicing such memberships could not be performed until the following year when such net income would be realized.

The method of accounting employed by the plaintiff during the calendar years 1953 and 1954 and prior years in keeping its books and records clearly reflected its net income for such years. The plaintiff's income tax returns for 1953 and 1954 were prepared in accordance with the method of accounting employed in keeping its books and records and clearly reflected the net income for these years. This conclusion and the findings set forth above are supported by the overwhelming weight of the documentary evidence and expert testimony.

Respectfully submitted,

Marion T. Bennett, Commissioner.

[fol. 28]

Excerpts From Testimony Before Commissioner

AFTERNOON SESSION (1:30 o'clock p.m.)

Commissioner Bennett: Mr. Bomar.
Mr. Bomar: Professor Paton, please.

Whereupon—WILLIAM A. PATON, a witness produced on behalf of the Plaintiff, being first duly sworn by said Commissioner, was examined and testified as follows:

Direct examination.

By Mr. Bomar:

Q. Would you please state your name and address?
A. My name is William A. Paton. My address is 2203 Hill Street, Ann Arbor, Michigan.
Q. What is your occupation?
A. My major activity is college teaching.
Q. And what is your present position?
A. My present position is Edwin Francis Gay University Professor of Accounting, and also Professor of Economics at the University of Michigan.
Q. Professor, how long have you served on the faculty of the University of Michigan?
[fol. 29] A. With minor interruptions I have served there for 44 years.
Q. And when were you made a full professor?
A. In 1921.
Q. Please describe briefly your educational background.
A. My undergraduate college work was taken at Michigan State Normal College and the University of Michigan. I held three degrees from the University of Michigan, including the Ph.D. granted in 1917.
Q. What was the subject of your doctoral dissertation?
A. The topic of my dissertation was accounting theory with special reference to the corporate form of enterprise.
Q. Professor Paton, are you a Certified Public Accountant?

A. Yes, I am. I hold a certificate granted by the State of Michigan.

Q. Are you the author of any books, texts or treatises on the subject of accounting?

A. Yes, I am an author or co-author of 15 or 20 books and treatises. Perhaps the most important and best known among the textbooks are "Essentials of Accounting" first published in 1938, "Asset Accounting" published in 1952, and "Corporation Accounts and Statements" published in 1955. I might also mention that I was editor and the major contributor also to two editions of the Accountants Hand-[fol. 30] book.

Q. Are you at the present time serving in any capacity as a consultant for the United States Government?

A. Well, I have one small connection at the present time in that I am serving as a member of the Educator-Consultant Committee, it is called, of the General Accounting Office.

Q. And do you now or have you ever served as a member of any committee of the American Institute of Accountants?

A. Well, yes, I served between eleven and twelve years as a member of the Committee on Accounting Procedure of the American Institute of Accountants, now called the American Institute of Certified Public Accountants. That, I think, is my principal assignment in that Institute.

Q. Professor Paton, have you, at my request and at the request of other attorneys in cases where you have testified as an expert witness on the subject of accounting, prepared a written statement which describes your educational background, your teaching appointments, the books and articles which you have written, the professional societies of which you are a member, your professional and business experience and other activities which are relevant to your qualifications as an expert witness on the subject of accounting?

A. Yes, sir, I have.

Mr. Bomar: Your Honor, at this time I would like to [fol. 31] offer as Plaintiff's Exhibit No. 8 this statement of qualifications of Professor Paton, and I would like to have him recognized as an expert witness on the subject of accounting in this case.

Commissioner Bennett: Have you seen the memorandum, Mr. Kane?

Mr. Kane: No, but I am familiar with Professor Paton and I have no objection to this going in evidence, and I recognize Professor Paton as an expert in the accounting field.

Commissioner Bennett: The statement is received. The witness qualifies.

(Document containing data regarding training and experience of Prof. William A. Paton was marked Plaintiff's Exhibit No. 8 and received in evidence.)

By Mr. Bomar:

Q. Professor Paton, have you read the petition filed by the American Automobile Association in this case, Government's answer, the agreed stipulation of facts, and have you heard the testimony given by witnesses who preceded you in this case?

A. Yes, sir, I have read the petition and the answer and the stipulation and have heard the testimony that has been given up to date by the preceding witnesses.

Q. Are you familiar with the method of accounting em- [fol. 32] ployed by the American Automobile Association during the years in issue in accounting for dues received in advance from members of its divisions?

A. Yes, speaking rather generally, I would say that I am familiar with the method that has been employed by the Association.

Q. And are you familiar with the change in Plaintiff's method of accounting which the Commissioner of Internal Revenue seeks to force upon Plaintiff?

A. Yes, sir.

Q. Professor Paton, if the American Automobile Association is incorporated as a non-stock membership organization and finances its operations by means of dues prepaid for twelve months in advance by members of its divisions, and in return for such prepaid dues the American Automobile Association is obligated by contract or otherwise to render specified services to its members over the ensuing 12-month period following receipt of such dues, would it be

proper, in your opinion, under generally accepted accounting practices for the American Automobile Association to treat as revenue or income in the year of receipt the entire amount of such dues even though the Club is obligated to render services to its members for a period which extends beyond the close of the taxable year?

Mr. Kane: Your Honor, before answering that question, [fol. 33] I want to interpose an objection to Professor Paton's testimony as an expert in this case, on the basis that I consider this testimony to be given in the form of an advisory opinion to the Court and that the issue before this Court is a legal issue rather than an accounting issue, and that any answer that he will give here today will be an advisory opinion, which we take the position is not proper matter for expert testimony, no more than having a lawyer testify as to what the law should be.

Mr. Bomar: Your Honor, in determining whether expert testimony is admissible, my understanding of the law is that first we must determine whether the matter under inquiry is subject to opinion testimony from the point of view of whether the issue involves an area where expert testimony would be helpful.

In my opening statement I called attention to the fact that the taxpayer is required to compute net income in accordance with the method of accounting used in keeping its books and records unless such method does not clearly reflect income.

I also call your attention to the fact that the statute, both section 42 of the 1939 Code, and section 451 of the 1954 Code, requires that all items of gross income shall be included in the gross income for the taxable year when received by the taxpayer unless the methods of accounting [fol. 34] permitted such amounts to be properly accounted for as of a different period.

It seems to me that no matter what the witnesses who I propose to qualify as experts to testify in this case, it would have no bearing on the ultimate legal question to be resolved, whether tax law differs materially from generally accepted accounting principles.

Furthermore, there are numerous cases in which experts have been permitted to testify on the ultimate issue involved in the case, such as reasonableness of salaries. Experts are qualified in my view even when they testify on the sole issue in the case, such as valuation of property when that is the sole issue in a case.

I think that the issue involved in this case clearly is one in which expert members of the accounting profession are peculiarly qualified to render competent testimony.

Commissioner Bennett: The objection is overruled.

Mr. Kane: May I have an exception, and the same throughout the testimony of experts, an objection and exception?

Commissioner Bennett: You may.

Mr. Kane: Thank you, Your Honor.

The Witness: No. It would not be proper.

By Mr. Bomar:

Q. And why not?

[fol. 35] A. It would not be proper because the procedure that you described is in conflict with an absolutely basic principle of accounting, namely, that we must distinguish between a financing transaction and revenue or income transactions. I regard that as pretty close to the cornerstone of accounting.

Q. What do you mean by a financing transaction?

A. Briefly a financing transaction is a transaction in which funds are raised by any organization or enterprise to get it going and carry on its activities. There are three main ways of doing it. Speaking of corporations and organizations generally, substantial funds are raised from stockholders. Another source, a second major source is borrowing at the banks or from other lenders. Third and actually quite an important source is that of advances by members or customers.

Many companies would utilize primarily the first two sources, acquiring funds from stockholders or from creditors such as banks and other lenders, especially in a membership, a non-stock organization, and I understand that the American Automobile Association is of that nature, it

is not only commonplace but appropriate, one might also say, naturally to rely on the members for advances to get the funds necessary to carry on operations.

Q. What do you mean by a revenue or income trans-
[fol. 36] action?

A. A revenue or income transaction occurs when some organization, corporate or otherwise, furnishes a product or renders services and no revenue can emerge in the very nature of the case until product is furnished or services are provided. That I regard as an undisputable principle of accounting and it is universally recognized, as far as I know, in the accounting field.

Q. Professor, would you give us an example which would distinguish between a financing transaction and a revenue or income transaction?

A. Well, there are, of course, many examples in business operation. I might be permitted perhaps to try my hand at a very simple hypothetical example in an effort to bring out what I regard as the underlying point involved.

Suppose, Mr. Bomar, that at about the end of a taxable year you deposited $100 with your tailor in connection with an order, which he has agreed to, to make you a nice overcoat at a cost of $300. Now, assuming that we are approximately at the end of his fiscal and taxable year—I don't know that it is even necessary to throw that assumption in—but at any rate when that transaction occurs you are depositing $100 with your tailor in connection with this order for an overcoat.

Proper accounting for a tailor would require the estab-
[fol. 37] lishment of a liability account in your name for the amount of that $100 which you deposited with him as a means, perhaps, of helping to finance his purchases of materials and other costs to be incurred in the making of this coat. He is just in the same position substantially as if he had gone to the bank and borrowed $100 or you had signed his note at a bank for $100.

Now, if that is the situation still at the end of his taxable year, it is absolutely essential that he show a liability to you of $100 in his financial statement and it would be absolutely incorrect for him to treat that $100 as an income item.

Now, in the following year when he makes up the coat, buys the material and makes up the coat, he now has a revenue transaction, and the proper accounting for that would be to recognize a revenue or sale, as we often say, of $300 and a charge to you as a customer of precisely that same amount.

Now, we have arrived at the final stage of settling these two claims, your claim against him for the advance of $100 and his claim against you for providing you with a product, this coat, at an agreed price of $300.

Now, two methods of settlement are open to you: You might pay the tailor $300 and then he might pay you $100, returning the amount of your advance, which, if he had [fol. 38] borrowed from the bank, that is what he would do. Or instead of that he may deduct the $100 claim in your favor from the $300 claim in his favor and bill you for $200. That's precisely the way that invoice would be typically set out, but that does not alter the fact that in the first year we have a financing transaction in which you provide the tailor with $100 in just as clear-cut way as if he had gone to the bank to get it, and that remains a liability, I assume, at the end of the year, and the second year revenue emerges and the settlement of these claims also develops.

Q. Professor Paton, can you or not apply the principle of accounting you have discussed and illustrate it to the facts in this case?

A. Yes, I think I can as I understand the facts.

It seems to me that my little example is absolutely on all fours with the facts in this case, that when a member makes a deposit of any amount of money in advance of the rendering of service by the association or one of the constituent branches, it is clear that we have no revenue transaction, there is no such thing at that stage as revenue or income. Instead we have a bit of financing and I don't regard it of any consequence whatsoever that the amount advanced might be quantitatively of equivalent to a year's dues. I think it is at that point some people get confused about such cases.

[fol. 39] The plain fact is that at that point the Association has incurred a liability, the Association has received

funds from members in lieu of other methods of financing. Now, as through the passage of time the Association renders services as agreed, the revenue transaction emerges, and under prevailing practice an arrangement is worked out under which the liability is discharged instead of a payment by providing service as agreed. That doesn't alter one iota the fact that one transaction is raising funds and the other transaction is the revenue transaction.

Q. Professor Paton, does sound accounting practice demand that there be a distinction between the receipt of advance dues which you described as a financing transaction and the rendering of services which you describe as an income or revenue transaction?

A. Yes, it certainly does. First, I perhaps have already said I consider it a basic principle of accounting practice to draw that distinction, and I think it is universally acknowledged among accountants. I don't know of any reputable accountant that would hold anything to the contrary, and I think that is true for a long period of years.

Q. Professor Paton, the pleadings in this case make it clear that the American Automobile Association uses the [fol. 40] accrual method of accounting. Under the accrual method of accounting, is it essential that income be recognized only as services are rendered or made available?

A. Yes, it is, but I would like your indulgence to clear up something there.

In my opinion it doesn't make any difference whether the taxpayer is on the so-called accrual basis or on the so-called cash basis, as I understand the situation. Whichever basis he is on it is absolutely improper, it is unsound accounting for a taxpayer to treat money secured at the bank as if it were revenue, or money secured with which to operate, from members, as if it were revenue.

My understanding of the cash basis of accounting—and I am subject to correction, because I think I know something about this—but we do have a system under which the taxpayers—we refer to the taxpayer in that category here—is permitted under some types of circumstances to defer the recognition of revenue that has already been earned and produced until cash is received.

I report my return on the cash basis. I report the cash paid to me each year as my cash income.

Q. Professor Paton, if receipts in the form of advances by members or customers are treated as taxable income entirely in the year of receipt, is there a possibility that taxable income over a period of years will be overstated [fol. 41] and that the total tax collected from the particular taxpayer will exceed the statutory rate applicable and may even include a levy on capital funds in the guise of an income tax?

A. Yes, there is very clearly such a possibility. I might take perhaps a rather extreme example that is not literally identical to the case we are considering, but it seems to me it is the same principle. Let's suppose a new company was organized to make machine tools or some other products and the funds to build the buildings, let's say, were secured from the stockholders and funds to buy materials were secured from some interested customer who has ordered quite a number of these units of product that the company is going to make. Now, if a part of the money advanced by that customer who is making these orders were seized as income taxes, not only would we be taking money obviously raised to acquire these inventories but we would be taking money before we know whether the company is going to be able to operate at a profit.

You would seize funds that are being used to finance a business prior to the production of revenue and the assembling of the costs, and you may very well have a tax levy when there is literally no income at any point.

If, for instance, the price that was agreed upon for this customer I am thinking of weren't high enough to develop [fol. 42] some of the cost that might unexpectedly appear, it might be that the company would operate at a loss. It seems to me that in such a situation it would be ridiculous to take some of that money and call it income.

Q. When in your illustration would the income for revenue purposes take place?

A. When the goods are provided for the customer as agreed by the contract.

Q. Professor Paton, when you refer to an income or a revenue transaction are you referring in general to items which appear in a profit and loss statement, or are you not?

A. Yes, in a profit and loss or income statement. I prefer the term "income statement," but it doesn't matter and I am using them both because sometimes we find the term "revenue" and the "total sales price" and sometimes we apply the net income to a net or intermediate figure, but the elements I am thinking of are income statement elements, yes, sir.

Q. Professor Paton, can the error which you described in accounting in the case of the machine tool manufacturer happen to such an association as the American Automobile Association?

A. Well, it seems to me it clearly can. I don't know the details of the Association, but it seems to me they clearly can.

[fol. 43] If I might try to focus on something to bring out the point, let's suppose, for instance, that the Association toward the end of a taxable year staged quite a membership campaign and got quite a bit of money in toward the end of that year covering membership so that can operate as of the first of the following year. It might well happen that unexpected developments may create an element of cost when the Association undertakes to furnish the services or provide the services for the membership as agreed, a level of cost might emerge that would wipe out any possible income margin with respect to this batch of customers during the year in which revenue were being produced and costs being incurred. In fact, I would be surprised if that sort of thing wouldn't happen from time to time wherever funds are levied upon in the gross prior to the incurring of costs or the creation of the revenue itself.

Q. Professor Paton, you will note from the agreed facts in this case that the American Automobile Association recognizes advance dues as revenue or income as services are made available over a period of time of the membership. Will you please state whether or not there is any justification for recognizing as income or revenue advance dues on a time basis?

A. Well, it seems to me there is considerable justification. The contract itself is on a time basis. I feel especially [fol. 44] for tax purposes the important thing is that the

year's recording be handled in such a way that for the year the transactions with members are treated soundly, as I have tried to suggest. The time basis does not offend me at all. I would doubt if there is any other basis that is more realistic, especially when you consider the practical side of it and the way the thing is regarded by both the Association and the member.

I might say I am probably one of the oldest members of the Michigan Automobile Association and it is my understanding when I deposit my dues that over a stated period of time the thing that I am acquiring is the right to receive a series of services of one sort or another specified in the arrangement, and hence proration over a time, as time passes, strikes me as being perfectly realistic and reasonable.

Q. Professor Paton, Mr. Arthur I. Cooper has testified that even had advance dues been pro rated as costs were incurred on an average cost per member per month basis, that the recognition of revenue during a particular year and the amount of the liability as of the end of the year would not have been materially different than if revenue is recognized out of the advance deposits on a time basis. Would that testimony fortify your conclusion that time is a proper yardstick for measuring the obligation that the [fol. 45] American Automobile Association is performing or the expiration of its liability to render services?

A. Yes, I think it would to some extent. That is, I would be inclined to recommend that such study be made from time to time just as a means of seeing whether the relationship can be properly recorded on a time basis.

My feeling still is that time basis is thoroughly sound and that cost data of the kind presented that I was listening to this morning, are primarily important for the purpose of testing the general reasonableness of the time basis and seeing whether there is anything capricious or outlandish about such basis.

Q. The feeling has been expressed by others that such a method of accounting would be artificial if advance dues were recognized on a time basis unless it was proved that there was a relationship between the income and the services to be rendered. Do you agree with that view from the accounting point of view?

A. No, I don't agree with that point of view or any other point of view as far as understanding the operations of an automobile club or an association, though such understanding as I have, if anybody can find a better basis I would like to see them do it.

The Club, the Association, by contract agrees to provide a package of services and conditions. Now, fluctuations [fol. 46] between months, if there were such, wouldn't frighten me particularly, because I would be looking back as a whole, and I think time is a very good and realistic basis for saying that the Club has undertaken to provide a package of services over a period of time, but I don't object, on the other hand, to studies which I think should be made from time to time to test things out and see how other aspects of the situation fortify or raise questions about the time basis. I wouldn't want to insist here the time basis is the only basis with which one might spread the revenues of a service organization.

Q. Professor Paton, if you were employed by the American Automobile Association as an independent expert to advise them how to set up their books and records in order to reflect and recognize advance dues on a proper basis, what method would you recommend?

A. Well, I might quibble a little bit about the account titles, maybe prefer something a bit different, but I would emphatically recommend that the Association's usual method of accounting which sets up at the end of each year on a reasonable basis the outstanding obligations to members as a liability and to recognize revenue as services are rendered or made available through the year. In fact, I can't see any justification for anything else. Now, I understand that is what the Association has been doing for many [fol. 47] years, and if my understanding is correct I wouldn't have any quarrel with them on any essential points whatsoever.

Q. Professor Paton, is the method of accounting for advance dues which the Commissioner of Internal Revenue seeks to impose upon the American Automobile Association in accord with generally accepted accounting principles?

A. No, sir, it is not. It is absolutely 100 percent in conflict and always has been where it has been tried, and I

might add it is entirely indefensible. It should not even be considered debatable, and I was disturbed for many years handling this correctly, in income tax and other connections we started trying to do the wrong thing.

Q. Professor Paton, I call your attention to page 282 of the book to which you have referred, "Corporation Accounts and Statements," wherein you write:

> "The term 'deferred revenue' is sometimes applied to balances representing amounts collected from customers or clients in advance of the delivery of goods or the furnishing of service. As emphasized later, such balances are *liabilities, not revenue credits deferred* or otherwise."

Does the statement which I have quoted apply to the account entitled "Deferred Revenue—Membership Dues" referred to in Paragraph 7 of Plaintiff's Petition?

A. Oh, yes, clearly that is an example of the very kind [fol. 48] of situation I have in mind there, but those balances are clear-cut liability balances and I personally prefer to describe them as advances by customers or something of that kind rather than just a particular type.

Q. I also ask you to turn to page 416 of the same book, of which you and your son are the authors, and in which you write:

> "A type of liability frequently misinterpreted is represented by 'unearned' or 'deferred' revenues so-called . . . the proper general caption for such item is 'Advances by Customers' and that should be reported in clear-cut fashion under liabilities."

You continue on page 417:

> "In a number of cases the Internal Revenue Service has taken the almost incredible position that advances by customers constitute revenue for tax purposes in the period received, even if the taxpayer's accounting is on a strict accrual basis and even if no goods or services have been delivered in such period."

s this still your view?

A. It most certainly is and it always has been, I might say, as we considered this a very elementary point in accounting, and I have never heard of anything ever being preached in a classroom or anywhere else.

[fol. 49] Commissioner Bennett: You have taught it that way for 44 years?

The Witness: Yes.

Commissioner Bennett: And when was your book published from which the quotation has been made?

The Witness: This particular book, Your Honor, was published in 1955, but you will find the same material I have written with the exception that in most of them you won't find this comment about the Internal Revenue Service.

By Mr. Bomar:

Q. Professor Paton, we have been talking about the income account of the Association primarily. I want now to direct your attention to the balance sheet as contrasted with the income account. The balance sheet of the American Automobile Association is evidence in this case established here and always as a liability account, which is referred to as "Deferred Revenue Membership Dues." Does sound accounting practice require this amount to be shown as a liability on the balance sheet of the American Automobile Association?

A. In my judgment it most certainly does. It is a liability.

Q. Professor Paton, would you as a certified public accountant certify to the accuracy of the income statement or the balance sheet of the American Automobile Association if the Commissioner succeeds in changing its method of accounting?

[fol. 50] A. No, I certainly would not even consider it for a moment. The thing is unsupportable and I wouldn't know offhand of any professional accountant who would say differently.

Mr. Bomar: Thank you, Professor Paton.

Mr. Kane: May we have a short recess, Mr. Commissioner?

Commissioner Bennett: We will take a ten-minute recess.

(Short recess taken.)

Commissioner Bennett: Proceed.

Cross Examination.

By Mr. Kane:

Q. Professor, you talked about the accrual method of accounting and deferred revenue or deferred receipts method. In normal accrual accounting, as I understand it, you take into account the amount when it is billed to a customer whether or not at that point you have rendered the service to that client; isn't that right?

A. No, sir.

Q. It is not right?

A. No, sir.

Q. In other words, if I go to a store and purchase a suit in late December which is not furnished to me until some time in January, the store bills me the 30th of the month, the 30th of December, they do not accrue that as income in December?

[fol. 51] A. I couldn't guarantee that there is no store that does not violate the principle, but that is something we are very touchy about in accounting. That would not be correct accrual accounting for revenue to be credited—you used the word there—in December with a sale in which the furnishing of the product doesn't occur until later.

Now, there is one possible exception to that, sir. If the circumstances were such that the coat was already in existence and was segregated as the property of the customer, it is the exception but I don't think we need refer to it in the retail situation, but there might be instances the fact that the product had not physically left the possession of the vendor would not be the decisive thing provided the product is there waiting delivery and all the conditions have been taken care of. For instance, a wholesaler might order a big shipment of cans from a canning factory for canning tomatoes, let's say, and if the customer had those tomatoes on hand and set them aside as the property of the customer, I would be willing to say that under some of those condi-

tions you do have a revenue transaction and that the billing is validated by a revenue transaction. But, speaking generally about manufacturing and trading companies, I would say that the last thing in the world any of us would tolerate in accounting would be the inclusion in revenue in the current year of prospective sales even though normal billing or [fol. 52] formal billing had been instituted.

Q. If they billed me in December and the coat was delivered to me in December and I did not pay for it until some time in February or didn't pay for it at all, when would it be accrued as income?

A. In that situation the revenue would be recognizable under proper accounting in the month of December regardless of the fact that the transaction might turn out to be a bad debt. In other words,—

Q. An adjustment would be taken in the following year as a bad debt?

A. The bad debt loss would occur later when the account went sour.

Q. Professor Paton, you called these dues, in effect, advances from the members. Now, you also said, I believe, that advances are usually thought of as subject to a service being performed or a refund being made if the service is not performed. I believe you used a hundred dollar example.

A. Yes, I didn't say specifically anything about refund.

Q. But I am asking you about refund.

A. Okay.

Q. I think it follows in the same order. Do you know if the dues in this case are subject to refund?

A. I don't know for certain about that, sir.

[fol. 53] Q. May I ask you do you know as a member of the Michigan Automobile Club, which you say you have belonged to for many years, whether there are or have been years in which you required no service?

A. There have been years in which I did not require them to pull me out of the ditch or anything of that kind, but I do not consider that is what I am paying for. I am buying the availability of the service, I am buying the protection and that is what I am paying them for when I take out member-

ship. I hope they will not have to pull me out of the ditch, in fact.

Q. The same as insurance?

A. I consider it a very close relationship between an insurance situation and this type of situation with regard to the type of product.

Q. But it is conceivable they have a few cases, a few members or many members who ask for nothing as an item of direct expense to the organization during the following year. I am not talking about overall management salaries but pulling a man out of a ditch, asking for travel folders. Is it possible there would be many members that would ask for no service of that type during a year?

A. Oh, yes, I think that is clearly involved. You are dealing with a group or pool. Any pooling or risk situation, particular members may in a particular year require [fol. 54] very little of a specific service that is rendered to certain other members. I wouldn't know what the experience on that would be, but I would think it would be rather irregular between individual members.

Q. But your fixed liability as you see it in contrast to the overcoat transaction is their being liable to render these services?

A. Well, I have always understood that is what I am buying and that is the regular understanding that I am buying the availability of services, the protection and paying for it reasonably, and I hope I won't have any bad luck.

The specific intentions, they are agreeing to furnish certain services—there is a considerable difference, I might add, on varying types of business of that kind. Frankly, the irregularity of the actual furnishing of the maps and helping you out when you run out of gasoline and so on, I frankly don't think that has a blessed thing to do with the over-all accounting.

Q. Now, this view of others that you mentioned you took issue with, would you mind clarifying for the record whose views they are?

A. I was asked, I believe, a question to this effect, that there are others who regard the recording or recognizing of service on a time basis as artificial. There was nothing mentioned as to who these others are in question, but my

[fol. 55] answers simply were if there are folks of that stripe I don't agree with them.

Q. It might be the Supreme Court?

A. Are you asking me, sir?

Q. Yes. You heard the testimony this morning and the opening statement?

A. Yes. I am not familiar with the details of the Michigan case, but I am quite sure I saw reference to it in the papers originally and I heard what was said here today and have some little familiarity with it, and I don't know what facts were presented to the Court, but on this particular point we have under consideration here now the Court reached absolutely the wrong decision.

Mr. Kane: That is the reason for my objection to this type of testimony, Your Honor, it is an advisory opinion.

By Mr. Kane:

Q. Now, there were some charts shown here about expenses. You said that you believed that the proper method was to pro rate on a time basis the dues, that expenses as I recall it would be for testing purposes from time to time to see how your system was working out. Is that a fair statement?

A. Yes, that is my recollection. I just add this word, that I consider the basic question I have been addressing myself to, this question of making sure we have a liability [fol. 56] appropriately calculated set up at the end of each accounting period and that the revenue transaction and the services rendered be recorded over a period of time in a reasonable way.

Now, I don't hold any rigid plea for a strict time basis. It looks to me as though it is the most realistic and practical and sensible in this situation.

Q. You would say, then, that it wouldn't be proper to prorate expenses over the same year? A. No, I wouldn't say that.

Q. You would not say that it was not proper to prorate expenses?

A. No.

If I might elucidate very briefly on that. The accounting that is on an income statement, I regard in this way: The

measure of the revenue up at the top of the statement I think is a relatively simple thing. The determination of the costs that are properly applicable to that revenue is a much more controversial subject. I don't think we in accounting do as good a job in that area in general as we do in the area of simply setting up the revenue figure at the top of the income statement, but I am a thorough-going believer in our perfecting our charges for deductions in so far as it is feasible and practical to do so, so that we have a reasonable relationship between the charges and the [fol. 57] revenues.

Q. I believe you testified that in effect this method that the Commissioner advocates would at times result in his taxing as income either capital or loans not actually earned; is that correct, sir?

A. It seems to me it is quite likely to result. You are levying a tax upon receipts that in the first instance are funds advanced to finance activities, so you are levying a tax to start with on a gross figure. It seems to me quite possible, quite likely in fact, that from time to time the levying of a tax prior to the creation of a revenue and the expense accounting will result in seizure as income taxes of funds that are not income in any sense of the word.

Q. Now, that is from time to time, in other words, not just at the beginning of the business but from time to time to put some changes in the number of memberships that will occur?

A. Yes, unexpected changes in expenses, loss periods and so on. Now, I haven't worked out any examples to my satisfaction in detail in that area, but that's my impression, and, of course, we can see at the beginning of a business, we can see the thing more clearly, but what I do from time to time say, that that situation would arise after the operating history, after you got rolling presumably from time to time. But I don't think we can hope that there will be a [fol. 58] coincidence from year to year between the advances by customers and any organization that utilizes that method of finance and the volume of service and product produced in that year. That would be a sheer coincidence if they are identical. That creates the possibility of levying taxes on funds that not only are not income to start with

but will never be in any sense of the word an element of net income.

Q. Now, continuing that, as long as you have a curve upward of members and you are prorating part of the income into the next year for the revenue, gross receipts, wouldn't it follow that if the expenses were increasing to serve more members that you would be putting in part of the expenses in the latter months of the year, you would be increasing the expenses so that your net income would always be less as long as you have an upward curve of members?

A. I am not sure I follow you. I don't see anything about an automobile association, or, for that matter, any other business which deserved the general conclusion that there will be a trend upward of revenues or a trend upward or downward of expenses. That would depend on a lot of circumstances, but, to my mind, sir, there is a fatal defect in taking money as income before income emerges, in that you have deprived the taxpayer of funds too early, and in the second place you run the risk, but even year by year there will be substantial injustice done. That's a question I think [fol. 59] you would have to postulate a lot of facts rather carefully how it would work out.

I am not trying to evade your question, but I don't know the answer.

Q. My question is premised on exhibits put in by the Plaintiff, and I note that each year's expenses have gone up anywhere from three or four hundred thousand dollars to over a half million dollars in an exhibit right here, and my question is premised on the fact that some of those expenses during those years may have been applicable to the new memberships, the income from which is being turned over into the next year under the Plaintiff's method of accounting.

A. Oh, I think that is quite possible, that some of the costs that are incurred and are recorded as expenses currently by the Association, that we could find fault possibly with some treatment there. I wouldn't think in the automobile association business that they would be as serious as we might find in manufacturing and some other cases, but I would recommend, as I understand the Associa-

tion follows, [illegible] practice of spreading the commissions to salesmen, because they relate to a particular element received from the members.

Now, I wouldn't, on the basis of any information I have, want to be either critical or applaud the general treatment of this and that cost like office supplies and salaries of ste- [fol. 60] nographers and others. I don't know of anything strikingly wrong about that area of accounting for the Association, but I can't testify to the advantage or disadvantages of the things they are doing.

I said a little while ago, and I would like to refer to that in the field of determining the cost assigned to the volume of sales or services rendered, we do have a lot of difficult accounting questions.

Q. Why would you say that the salesmen's commissions that you just referred to are more direct expense than publications, road service or any of those things, other expenses incurred for a member?

A. Well, I don't know that I know enough about the operations of the Association to speak very positively on that, but it does seem to me that the commissions specifically related to amounts advanced by customers, that there should be some justification for spreading through the year by months especially if you are going to spread services rendered by months through the years, and wherever anything of that kind is substantial, I think you improve your accounting somewhat by appropriate spreading.

Now, when you come into the field of publication costs that is something like the question of advertising in business generally. I remember when I was in the Internal Revenue Service 40 years ago for a year, that we were [fol. 61] worrying about advertising cost, whether we should permit advertising cost as a deduction in the year in which the money was spent or the billing occurred, like some late advertising in the Saturday Evening Post, say, about this time of year, or whether we should try to insist on some method of deferral and, generally speaking, the method of deferral. You didn't try to do much with it because of the great difficulty in deciding when the results of some of these expenditures might be. Now, publication expense, I don't think I should pass judgment on that. I don't think I know enough about it, Mr. Kane.

Q. You gave as the only thing they now prorate is the salesmen's commissions.

A. Yes.

Q. In this case.

A. One other thing, I think it was mentioned the cost of accident insurance was prorated also.

Q. Yes, accident insurance. No, it is not prorated.

A. I understood it was and always had been.

Q. You heard some testimony this morning as to the change in 1954, which is the same thing we are talking about, and there was also mention of items on the books as of the end of the year, a small figure, roughly $44,000, which they treated as an accounts receivable in a memorandum form only, which was not placed on the books. Would you [fol. 62] say that proper accounting as described this morning would require them to include that or a portion of that $44,000 in their income for 1954 when they had been doing it each year up until then?

A. As I understand the change, and I may not be entirely clear on this, but as I understand the change it would not result in inconsistent accounting or any material change, because I would regard accounts receivable that had been set up at the time the application is received and no funds had yet come in as a sort of memo account and the corresponding credit in deferred revenue account or whatever you call it, I would call an offset and I would say the offset was a change in these two methods of accounting. That would seem to me preferable to what they would be doing previously and not inconsistent with it.

I am not undertaking to say that an accountant from absolutely every standard knows anything about it, but I don't see that that particular change is substantive to the matter I have been addressing myself to here.

Mr. Kane: I have no further questions.

Redirect Examination.

By Mr. Bomar:

Q. Professor Paton, Mr. Kane asked you your opinion as to whether the American Automobile Association had a

practice of making refunds to members, and as I recall your [fol. 63] testimony you stated that you didn't know. Would it make any difference under sound accounting practices from the viewpoint of distinguishing a financing transaction from a revenue transaction whether the Club does or whether the Club doesn't make refunds?

A. I don't think so. It is an incidental thing which would draw a little distinction advanced by a customer and a member and a bank loan, but if in incidental cases refunds were restricted or were not available it doesn't seem to me that alters the basic proposition that the money advanced by the customer is an advance and is not revenue.

Now, some subsequent development might involve some small adjustment, I don't know, but I think I can state that pretty clearly and flatly that I can't see that that fact settles the question at all of what is a revenue transaction there and what is a financing transaction. To me the advance by the member is the provision of some funds prior to the emergence of revenue.

Q. Professor Paton, under sound accounting practices is there any point in deferring expenses or in postponing the deduction for an expense unless it is a truly prepaid expense?

A. Well, that is a big question, Mr. Bomar. I think that the association of expenses with revenues is a difficult ques- [fol. 64] tion and involves many debatable points, because what we are really after is economic associates, and the word "prepaid" is a little bit restrictive to cover all such cases.

Q. Professor, is it debatable as to whether the advance dues should be deferred?

A. In my judgment it is not debatable and never has been.

Q. Professor, are you stating that even though no expenses are deferred, that you should still distinguish between advance dues and the recognition of dues as income?

A. There isn't any question in my mind but it is improper accounting to treat as a revenue, advances prior to the rendering of service, and that in itself—I am not going to condone any bad accounting for expenses by saying

that, but that's a distinct, basic consideration in getting started with your accounting at all.

Mr. Bomar: Thank you.

Recross Examination.

By Mr. Kane:

Q. Didn't you say that the normal advance for loan as we think of it would indicate the right to a refund if the service was not rendered?

A. It depends on the way the contract is drawn, but I think of the person or entity receiving such advances from [fol. 65] customers and members as incurring an obligation and the proper utilization of those funds or the return of such funds, and I don't know enough about all the types of contracts we have in this area just to know when a refund is in order.

We know sometimes in the fire insurance business you are entitled by agreement and sometimes by request to a refund, so that generally speaking the producing entity does unquestionably incur the obligation. Now, what the basic law is I couldn't say.

Q. We are not asking you the law, Professor. Wouldn't you say that is true in subscription income, that normally if you cancel your subscription, like a newspaper subscription, that you are entitled to a refund?

A. I was under the impression that quite frequently you are not.

Q. On a long-term contract?

A. That I am not sure of. If you had a four or five-year subscription—my impression is that those contracts usually provide that you are not entitled to a refund, but what the practice is I couldn't be positive.

Mr. Kane: I have no further questions.

Commissioner Bennett: Thank you, Professor. You may be excused.

(Witness excused.)

[fol. 66]

IN THE UNITED STATES COURT OF CLAIMS

No. 311-58

AMERICAN AUTOMOBILE ASSOCIATION,

v.

THE UNITED STATES.

Mr. Fleming Bomar for the plaintiff. *Messrs. Joseph E. McAndrews* and *Ivins, Phillips & Barker* were on the brief.

Mr. Jerry M. Hanovit, with whom was *Mr. Assistant Attorney General Charles K. Rice,* for the defendant. *Messrs. James P. Garland* and *Lyle M. Turner* were on the brief.

OPINION—Decided March 2, 1960

JONES, *Chief Judge,* delivered the opinion of the court:

The plaintiff, a motor club, seeks to recover Federal income taxes and assessed interest paid for the calendar years 1952 and 1953. The issue to be decided here involves the tax treatment to be accorded the prepaid income of an accrual basis taxpayer. The problem arises because club membership dues are paid to the taxpayer for 12 months in advance.

Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel. In addition to its activities as a national organization, the plaintiff operates directly, as divisions, ten local automobile clubs. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs operated as divisions of the plaintiff.

Plaintiff provides services for the members of the local divisions over the 12-month period following payment of

[fol. 67] dues. These services, although not completely uniform, generally included the following: (a) A travel service which included trip planning, tour books, accommodation directories, maps and recommended routes; (b) emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs; the road service was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions; (c) bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen; (d) personal automobile accident insurance; (e) a theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car; (f) in addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

The prepaid dues collected from members of its divisions were deposited in plaintiff's bank accounts with no restrictions as to their use for any of its corporate purposes. However, the dues upon collection were reflected in a liability account designated "Deferred Revenue—Membership Dues." Thereafter, a pro rata part of the dues was removed from the liability account and reflected in an "income" account. Dues collected from members who joined in the month of January were recognized as income in January only to the extent of 1/24 (a half of 1/12) of such collections, on the assumption that the average or mean date of the January collections would be the middle of the month.[1] Thereafter, 1/12 of the dues collected in January was taken out of the liability account and credited to income in each of the following 11 months (i.e., February through December). The remaining 1/24 of the dues collected in January was kept as a liability in the "Deferred Revenue—Membership Dues" account on December 31, but was subsequently recognized as income for January of the following year.

[fol. 68] Dues collected in each of the other months of the

[1] Plaintiff's taxable year was the calendar year.

calendar year were treated in the same manner. That is, 1/24 of each month's collections was recognized as income in the first month of membership, 1/12 of the amount paid was recognized as income in each of the following eleven months, and the remaining 1/24 was allocated to income in the month when membership expired. Commencing in 1954, the plaintiff, in order to simplify internal accounting detail, changed its procedure in the monthly accounting for dues by assigning 50 percent of the dues to income for the current year and allocating the other 50 percent as a liability which matured as income in the following tax year.

In preparing its income tax returns for the years in suit, plaintiff, an accrual basis taxpayer, excluded from the income received in each year that portion of membership dues which remained in the liability account ("Deferred Revenue—Membership Dues") at the end of the taxable year. It thus treated dues as income ratably over the 12-month period of membership, whether or not such period extended beyond the close of its taxable year.

Expenses which plaintiff considered to fall within the category of prepaid membership costs, e.g., salesmen's commissions and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were not deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that dues were recognized as income.

The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,337,813.44, representing $1,562,042.23 of prepaid dues collected in 1952 but not recognized as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,407.46 of advance dues collected in 1953 but not recognized as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year.

Plaintiff claimed that as a result of a 1954 net operating loss in the amount of $289,967.67, it was entitled to a net operating loss carryback *deduction* in 1952 in the amount [fol. 69] of $154,411.11, and a net operating loss carryback

deduction in 1953 in the amount of $135,556.56. Upon examination of the plaintiff's Federal income tax returns for the calendar years 1952, 1953, and 1954, the Commissioner of Internal Revenue disallowed plaintiff's deferral of income from one year to another, for years subsequent to 1953, thereby increasing plaintiff's 1954 net operating income from $353,279.09 to $481,557.59 and reducing plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49. The net effect of the Commissioner's determination was to reduce plaintiff's net operating loss carryback deduction to $14,412.49 in 1952 and to eliminate entirely any net operating loss carryback deduction in 1953.

The issue to be decided by this court is whether the Commissioner of Internal Revenue correctly determined that plaintiff's method of accounting—with respect to dues received from members of its divisions—does not clearly reflect plaintiff's income within the meaning of § 41 of the Internal Revenue Code of 1939 and § 446 of the Internal Revenue Code of 1954. Section 41 required that "the net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books . . . but . . . if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income . . . ."[2]

The Commissioner of Internal Revenue disallowed the deferral of income from one year to another on the ground that prepaid dues received under a "claim of right," without restriction as to their disposition, represents income in the year of *receipt* and should be taxed in that year regardless of the method of accounting employed by the taxpayer. This position is based on the claim of right doctrine enunciated by the Supreme Court in *North American Oil Co.* v. *Burnet*, 286 U.S. 417, 424 (1932). It is of

[2] To the same effect, § 446, Int. Rev. Code of 1954, provides that: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." However, "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

course fairly obvious that, once it is determined that pre-[fol. 70] paid income is required to be included in income in the year of receipt under the claim of right doctrine, it would necessarily follow that any other method of reporting would not "clearly reflect the income."

The opposite view, advanced by the plaintiff—that the claim of right doctrine does not relate to the question whether items that admittedly belong to the taxpayer may be attributed to a taxable year other than that of receipt in accordance with principles of accrual accounting—has been succinctly presented by Mr. Justice Harlan, dissenting in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 191-192 (1957).[3]

However, we do not find it necessary to resolve this issue, since we agree with the Government's contention that the method of treatment of prepaid automobile club membership dues employed by the plaintiff was dealt with by the Supreme Court in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, rehearing denied, 353 U.S. 989 (1957), and was held to be, at least for Federal income tax purposes, "purely artificial." In the *Automobile Club of Michigan* case prepaid membership dues were credited upon receipt to an account carried as a liability and designated "Unearned Membership Dues." *"During the first month of membership and each of the following eleven months one-twelfth of the amount paid . . .* [was] *credited to an account designated 'Membership Income.'* This method of accounting was followed by petitioner [a motor club] from 1934. The income from such dues reported by petitioner in each of its tax returns for 1943 through 1947 was the amount credited in the year to the 'Membership Income' account." 353 U.S. at 188. (Emphasis supplied.)

[3] "[The claim of right] doctrine, it seems to me, comes into play only in determining whether the treatment of an item of income should be influenced by the fact that the right to receive or keep it is in dispute; it does not relate to the entirely different question whether items that admittedly belong to the taxpayer may be attributed to a taxable year other than that of receipt in accordance with principles of accrual accounting." (*Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 191-192 (dissenting opinion) (1957).)

The Commissioner of Internal Revenue had determined that this method of accounting—which is essentially the same method used by the plaintiff in the case at bar—did not clearly reflect income. The Supreme Court, in affirming the action of the Commissioner, stated (353 U.S. at 189-190):

> [fol. 71] The petitioner does not deny that it has the unrestricted use of the dues income in the year of receipt, but contends that its accrual method of accounting clearly reflects its income and that the Commissioner is therefore bound to accept its method of reporting membership dues. We do not agree. • • • *The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member.* Section 41 vests the Commissioner with discretion to determine whether the petitioner's method of accounting clearly reflects income. We cannot say, in the circumstances here, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits. See *Brown* v. *Helvering,* 291 U.S. 193, 204-205. [Emphasis supplied.]

Although it would appear that *Automobile Club of Michigan* does not expressly rule out deferral of income,[4] we are constrained to interpret this language as a rejection by the Supreme Court of the accounting method advanced by plaintiff in the case at bar.

We are influenced in our decision by the language used by the Court to distinguish on their facts *Beacon Publishing Co.* v. *Commissioner,* 218 F. 2d 697 (10th Cir. 1955) (deferral of prepaid magazine subscription income) and *Schuessler* v. *Commissioner,* 230 F. 2d 722 (5th Cir. 1956) (reserves set up to meet future costs):

> In *Beacon,* performance of the subscription, in most instances, was, in part, *necessarily* deferred until the

[4] See *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. at 192-193 (dissenting opinion).

publication dates after the tax year. In *Schuessler*, performance of the service agreement required the taxpayer to furnish services at *specified times* in years subsequent to the tax year. In this case [as in the case at bar], substantially all services are performed only upon a *member's* demand and the taxpayer's performance was not related to *fixed dates* after the tax year. We express no opinion upon the correctness of the decisions in *Beacon* or *Schuessler*.[5]

But regardless of the underlying basis for the Court's rejection of "the pro rata allocation of the membership dues [fol. 72] in monthly amounts" as "purely artificial," we feel constrained by the decision in *Automobile Club of Michigan* to reject that same method of accounting for tax purposes in the case at bar.[6]

The plaintiff is therefore not entitled to recover and its petition will be dismissed.

It is so ordered.

Littleton, Judge (*Ret.*); Laramore, Judge, and Madden, Judge, concur.

WHITAKER, *Judge*, concurring:

From the enactment of the Corporation Excise Tax Act of 1909 and the first income tax act in 1913, it has been universally supposed that in order to "clearly reflect income" the taxpayers' accounting method must treat as gross income amounts received or accrued in the taxable year, with certain exceptions specified in the Code. The income under consideration here was received in plaintiff's taxable year. Plaintiff's method of accounting treats a portion of that income as not having been received in the taxable year and, thus, does not clearly reflect its income, unless it comes within the statutory exceptions. Those exceptions are, for example, reserves for depreciation, obso-

[5] *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. at 189, fn. 20. (Emphasis supplied.)

[6] Cf. *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520, 528-529 (2d Cir. 1959); *Automobile Club of Southern California* v. *United States*, Civil No. 1169-58, S. D. Cal., January 22, 1960.

lescence, and depletion, and, in the case of insurance companies prepaid premium reserves. The statute does not allow the deduction of reserves to anticipate expenses of meeting the demands of plaintiff's membership. What plaintiff, in effect, seeks to do is to deduct such a reserve from the income it received within the taxable year.

I also concur in the majority opinion.

Findings of Fact

The court, having considered the evidence, the report of Trial Commissioner Marion T. Bennett, and the briefs and argument of counsel, makes findings of fact as follows:

1. Plaintiff is a corporation with its principal office at 1712 G Street, Northwest, Washington, D.C. Plaintiff was incorporated in the year 1910 under the laws of the State of [fol. 73] Connecticut and was organized and is operated as a non-stock, membership corporation.

2. Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel.

3. In addition to the activities described in paragraph two above, plaintiff operates directly, as divisions, the following local automobile clubs:

District of Columbia Division of AAA
(Metropolitan area, Washington, D. C.)
Louisiana Division of AAA (entire state)
Massachusetts Division of AAA (part of state)
New Hampshire Division of AAA (entire state)
New Mexico Division of AAA (entire state)
North Florida Division of AAA } (part of state)
South Florida Division of AAA }
Texas Division of AAA (part of state)
Wisconsin Division of AAA (entire state)
Wyoming Division of AAA (entire state)

4. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in ad-

vance received from members of the automobile clubs described in paragraph three and operated as divisions of plaintiff. Plaintiff provides services for such members over the 12-month period following payment of dues. The services provided by plaintiff for the members of its divisions during the years in issue, although tending to be parallel, were not completely uniform and included the following: (a) A complete travel service which included trip planning, tour books, accommodation directories, maps and recommended routes. (b) Emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs. The road service was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions. (c) Bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen. (d) Personal automobile accident insurance which included hospitalization, personal injury and death benefits on a sliding scale in the event of a motoring accident. The plaintiff contracted for the insurance on a group basis and paid the premiums on the group policies. [fol. 74] (e) A theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car. In addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

5. In order to make available and provide for the members of its divisions the services which plaintiff provides, plaintiff during the years in issue owned or rented offices in 39 to 41 different geographical locations and had on its divisions' payroll 495 employees in December 1953 and 603 employees in December 1954.

6. Plaintiff, commencing with the calendar year 1943, has been required to file Federal income tax returns and to pay Federal income taxes on its net income. Its Federal income tax returns are filed with the District Director of Internal Revenue, Baltimore, Maryland. The plaintiff's taxable year is the calendar year.

7. Plaintiff employs the accrual method of accounting in keeping its books and records and in filing its Federal income tax returns.

8. Plaintiff, within the time prescribed by law, filed Federal income tax returns with the District Director of Internal Revenue, Baltimore, Maryland, for the calendar years 1952, 1953 and 1954. The 1952 return reported a net income of $152,975.51, the 1953 return reported a net income of $352,125.84, and the 1954 return reported a net operating loss in the amount of $290,186.04.

9. Upon examination of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue made several minor adjustments which are not in issue in this proceding, the net effect of which was to increase plaintiff's 1952 net income to $154,411.11, to increase plaintiff's 1953 net income to $353,279.09, and to reduce plaintiff's 1954 net operating loss to $289,967.67.

10. Plaintiff claimed that as a result of its 1954 net operating loss in the amount of $289,967.67, it was entitled to a net operating loss carryback deduction in 1952 in the [fol. 75] amount of $154,411.11, and a net operating loss carryback deduction in 1953 in the amount of $135,556.56.

11. Upon examination of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue also determined not to recognize the method of accounting employed by plaintiff in computing its income derived from prepaid dues collected from members of its divisions during the calendar years 1953 and 1954, which is the issue in this proceeding. The net effect of such determination was to increase plaintiff's 1953 net income from $353,279.09 to $481,557.59 and to reduce plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49, with the further result that the Commissioner reduced plaintiff's net operating loss carryback deduction from $154,411.11 to $14,412.49 in 1952 and eliminated entirely any net operating loss carryback deduction in 1953.

12. The Commissioner of Internal Revenue determined the increase of plaintiff's income for 1953 by $128,278.50

and the reduction of plaintiff's loss for 1954 by $275,555.15 was in the following manner:

	1953 Adjustments	1954 Adjustments
Reserve for unearned and deferred income Dec. 31 of current year	$1,756,485.46	$2,039,264.43
Less reserve for unearned and deferred income Dec. 31 of prior year	1,562,042.23	1,756,485.46
Difference	194,443.23	282,778.97
Less		
Prepaid commissions:		
Dec. 31 of current year	398,482.36	405,706.15
Dec. 31 of prior year	332,317.63	398,482.36
Difference	66,164.73	7,223.79
Net additional income determined for the current year	128,278.50	275,555.18

All of the foregoing items are reflected in the plaintiff's balance sheets as of December 31 for the years involved, which were filed with its income tax returns for 1953 and 1954. The liabilities contain the account UNEARNED AND DEFERRED INCOME, and the assets contain the account PREPAID COMMISSIONS, but the latter account is not involved in the [fol. 76] items labeled prepaid commissions in the above tabulation. The deduction items employed by the Commissioner of the Internal Revenue Service represent plaintiff's asset account for prepaid membership costs. The plaintiff's assets for 1954 do not reflect any amount for prepaid membership costs, but its liabilities for unearned and deferred income reflect the approximate net difference between $2,039,264.43 and $405,706.15 in its 1954 balance sheet.

13. As a result of the adjustments described heretofore, the Commissioner of Internal Revenue on May 15, 1956, asserted an income tax deficiency against plaintiff in the amount of $58,083.58 for the calendar year 1952, and in the

amount of $137,907.48 for the calendar year 1953. These deficiencies in tax, plus interest of $2,019.37 for the year 1952 and $10,789.77 for the year 1953, were paid by plaintiff on May 25, 1956, and May 28, 1956.

14. On May 10, 1958, plaintiff filed timely claims for refund for each of the years in suit, which claims for refund raised the issues upon which plaintiff now seeks recovery in this action. On July 1, 1958, the Commissioner of Internal Revenue notified plaintiff by registered letter that its claims for refund had been denied.

15. Plaintiff, a nonstock, membership corporation, obtained substantially all of the funds necessary to carry on the operation of its divisions by dues from its members, paid for one year in advance.

16. Under the method of accounting employed by plaintiff during the years in issue, prepaid dues collected from members of its divisions were not regarded entirely as income for accounting purposes in the calender year of receipt, but instead prepaid dues were recognized and treated as income ratably over the 12-month membership period whether or not such period extended beyond the close of plaintiff's taxable year.

As of December 31 of each taxable year, the proportion of dues collected within the year which was applicable under plaintiff's system of accounting to memberships extending beyond the close of the taxable year was considered and recorded as a liability of plaintiff and was reflected on plaintiff's balance sheet with its tax return as a liability.

[fol. 77] Expenses which plaintiff considered to fall within the category of prepaid membership costs, e.g., salesmen's commissions, and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were not deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that dues were recognized as income.

17. During the calendar years 1953 and 1954, plaintiff recorded on its books and records, by months, the following

amounts of prepaid dues collected from members of its divisions:

	1953	1954
January	$257,698.02	$290,764.23
February	236,610.67	284,319.95
March	282,430.08	351,697.47
April	296,647.02	329,066.99
May	328,191.75	382,385.38
June	378,716.30	451,260.81
July	386,150.87	435,832.93
August	336,269.66	395,009.70
September	275,235.54	260,950.54
October	268,661.48	309,543.51
November	219,278.02	279,144.44
December	265,289.26	308,553.22
	3,531,178.67	4,078,529.17

This money was deposited in plaintiff's bank accounts with no restrictions as to its use for any of its corporate purposes.

Section 4 of the bylaws of the American Automobile Association specifically provided for the use of funds and reads as follows:

> SECTION 4. *(Use of Funds)* This corporation shall use its funds only to accomplish the objects and purposes specified in Section 3, and no part of said funds shall inure, or be distributed, to the members of this corporation. On dissolution the funds of the corporation shall be distributed to one or more regularly organized charitable organizations to be selected by the Board of Directors.

18. Under the accounting system employed by the plaintiff from 1931 through 1953 prepaid dues collected from members who joined in the month of January were recognized as income in January to the extent of 1/24 of such collections, on the assumption that the average or mean date would be the middle of the month. Thereafter, [fol. 78] 1/12 of prepaid collections for January was trans-

ferred or allocated to income for each of the following 11 months, and 1/24 of January collections remained a liability on December 31 and was transferred and recognized as income for January of the following year.

Prepaid dues for each month of the calendar year were treated in the same manner, that is, 1/24 of such collections was transferred and recognized as income in the current month when collections were made, 1/12 of such collections during the following 11 months and 1/24 thereof in the last month when membership expired. The monthly collections of prepaid dues during a calendar year which were recognized and transferred to income during the current year and the portion thereof remaining in the liability account at the end of the year, which was entitled DEFERRED REVENUE MEMBERSHIP DUES, UNEARNED AND DEFERRED INCOME or some similar title, appear in the following tabulation:

	Portion Treated as Income for the Current Year	Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year
January	23/24	1/24
February	21/24	3/24
March	19/24	5/24
April	17/24	7/24
May	15/24	9/24
June	13/24	11/24
July	11/24	13/24
August	9/24	15/24
September	7/24	17/24
October	5/24	19/24
November	3/24	21/24
December	1/24	23/24

The allocation of prepaid dues each month facilitated the preparation of monthly statements of income and expenses. Had monthly collections been equal for each month during a year, the amount recognized as income during the current year and the amount remaining as a liability at the end of the year would have been equal under the foregoing apportionments.

19. Under the method of accounting employed by plaintiff, the proportion existing between dues collected from members of its divisions within a calendar year, which dues [fol. 79] were recognized as income during such year, and the proportion of such dues regarded as a liability at the end of such year was as follows for the calendar years 1949 through 1954:

	Portion Recognized as Income During the Year Collected	Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year
1949	49.9%	50.1%
1950	50.0%	50.0%
1951	50.2%	49.8%
1952	50.6%	49.4%
1953	50.3%	49.7%
1954	50.0%	50.0%

20. Commencing in 1954, in order to simplify much internal detail, the plaintiff changed its procedure in the monthly accounting for prepaid dues by the assignment of 50 percent to income for the current year and 50 percent as a liability which matured as income for the following year.

Plaintiff also adjusted certain inconsistencies in its prepaid expense account in 1954. Some division managers were paid a straight salary, whereas others were paid a nominal salary plus incentive commissions based upon the number of members within the division. These incentive commissions had been previously charged to the prepaid expense account and prorated over membership periods, whereas such incentive pay was actually a part of the manager's compensation. It was treated as current expense in 1954 and thereafter. Also, guaranteed commissions to new salesmen for a certain limited period had been included with commissions earned on subscriptions obtained, as prepaid expense, and beginning in 1954 such unearned guaranteed payments were charged to current expenses.

The plaintiff continued the apportionment of prepaid dues collected and prepaid expenses for commissions and insurance over the period of membership as it had done previously. The basic method of accounting employed by

plaintiff in 1954 was consistent with that employed by plaintiff in 1953 and prior years.

21. The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,337,813.44, representing $1,562,042.23 of prepaid dues collected in 1952 but not recog- [fol. 80] nized as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,407.46 of advance dues collected in 1953 but not recognized as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year.

22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices and was, prior to the adverse determination by the Commissioner of the Internal Revenue, customarily and generally employed in the motor club field.[7]

The Internal Revenue Service did not question the method of accounting employed by plaintiff in computing its net income until the calendar year 1954, at which time deficiencies were proposed for the calendar years 1950, 1951 and 1952, but plaintiff was not required to pay those deficiencies by reason of a compromise settlement.

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[7] Defendant offered no testimony. Plaintiff's testimony consisted of that of its staff auditors supplemented by outstanding certified public accountants testifying as experts who were, also, either familiar with plaintiff's problem or had some direct association with it and whose qualifications were not challenged. They were: *Dr. Wm. A. Paton*, for 44 years a professor of accounting and economics at the University of Michigan and an author and consultant on accounting. *George E. Baker*, Washington, D.C., resident partner of Ernst and Ernst, Certified Public Accountants. *Herbert T. McAuly*, a general and managing partner of Ernst and Ernst. *S. Alexander Bell*, partner in Peat, Marwick, Mitchell & Co., largest firm of Certified Public Accountants in the world.

23. The determination of additional income by the Commissioner of the Internal Revenue Service for the taxable years involved herein was made by including as income the advance payment of dues covering membership benefit periods in the following year and excluding those payments received in the prior year that covered membership benefit periods in the current year.

By taking into income for the current year the amount which plaintiff treated as a liability for servicing membership periods in the following year, the amount of such receipts would be reflected in the plaintiff's surplus account at the end of the current year. The plaintiff's balance sheet as of December 31, 1953, filed with its tax returns for 1953 [fol. 81] and 1954 reflecting the items involved, is compared with the balance sheet which would result from the adjustments by the Commissioner of the Internal Revenue Service in the following table:

	Balance Sheet on December 31, 1953	
	(a) Reported by Plaintiff	(b) Reflecting the Adjustments by the Commissioner of IRS
ASSETS:		
Cash	$1,941,723.88	$1,941,723.88
Prepaid membership cost	398,482.36	.....
Prepaid commissions	177,079.51	177,079.51
All other accounts, net	2,834,525.72	2,834,525.72
Total assets	5,351,811.47	4,953,329.11
LIABILITIES:		
Unearned and deferred income	1,756,485.46	.....
All other liabilities	1,063,462.99	1,063,462.99
Total liabilities	2,819,948.45	1,063,462.99
SURPLUS	2,531,863.02	3,889,866.12

24. The defendant contends that the sole issue is whether the Commissioner of Internal Revenue erred in refusing to allow plaintiff to defer a portion of income actually re-

ceived, without any restriction as to its use, from the year in which it was received to the following year when services might have to be performed under the membership contracts.

The plaintiff's gross income from dues was measured by collection for the period memberships were in effect during the current year. This included pro rata amounts of prepaid dues collected in the prior year covering membership periods that extended into the current year, but excluded prepaid dues collected in the current year for membership periods that extended into the following year. The membership service costs and other operating expenses paid or incurred during the current year were then deducted from such gross income for its determination of net income.

25. Restrictions on the use of funds represented by prepaid dues were not required or intended by the plaintiff's members. On the contrary, the receipt of prepaid dues from members constituted the principal source of plaintiff's operating funds as heretofore found. Funds from other sources, [fol. 82] such as sales of publications, materials and supplies, advertising, etc., were normally received only after the costs and expenses were incurred in producing such revenues.

There is no evidence that membership contracts, or certificates issued by plaintiff to its members, provided any restriction in the use of funds received by plaintiff for dues paid in advance. Plaintiff's financial responsibility is not questioned.

26. The plaintiff prepared and submitted tabulations of the aggregate costs incurred by all of its divisions in servicing all members thereof for each month of each year from 1948 through 1954. These tabulations were received as plaintiff's exhibits 2 through 7, inclusive.

Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have

been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed.

27. The proportions of prepaid dues transferred and assigned to gross income by the plaintiff on a pro rata monthly time basis are compared with the proportion of assignments under the average monthly cost bases for servicing memberships in the following table:

	Plaintiff's Pro Rata Method as Reported	Average Monthly Costs for Current Year	Average Monthly Costs over Prior 5-year Period
1953			
Apportioned to Gross Income during current year	50.3%	49.8%	50.4%
Deferred to the Following Year (reported as a liability at the end of the current year)	49.7%	50.2%	49.6%
1954			
Apportioned to Gross Income during the current year	50.0%	48.8%	51.0%
Deferred to the following year (reported as a liability at the end of the current year)	50.0%	51.2%	49.0%

[fol. 83] 28. The recognition, assignment and transfer of dues collected in advance to gross income on the basis of actual costs of servicing members is feasible under the accrual method of accounting, particularly in testing the results of prorating such collections on a time basis. It is not as practicable as the assignment of prepaid dues on a pro rata monthly basis because the current costs incurred must first be determined. The employment of a prior year's monthly costs or a composite of monthly costs for five prior years might not be as accurate as the method actually employed by plaintiff because of a constant increase in membership reflected over the years or by

abnormal costs of servicing members during one or more of such prior years.

When members paid their annual membership dues they became entitled to membership services over a period of 12 months, notwithstanding any variations in costs to the plaintiff in furnishing the services that might be required.

29. The plaintiff's membership for all divisions reflects a constant increase from month to month during 1953 and 1954. The minimum number of memberships in effect in 1953 was 220,435 in January and the maximum was 246,856 in December of that year. The minimum number of memberships in effect in 1954 was 249,805 in January and the maximum was 295,889 in December of that year. The average cost to plaintiff of servicing a member during the calendar year 1953 was $14.50 and the average cost for 1954 was $14.72.

30. The plaintiff's costs for servicing members were substantially in proportion to membership from year to year with reasonable constancy from month to month. The plaintiff's actual costs of servicing all members from 1948 to 1954 are set out in the following tabulation:

1948	$1,587,794.87
1949	1,698,144.27
1950	2,012,466.23
1951	2,614,396.96
1952	3,109,068.21
1953	3,377,389.91
1954	3,991,068.00

31. The actual average monthly cost per membership in effect during 1953 and 1954 and the percentage of the total [fol. 84] annual cost per member is reported in the following tabulation, with the percentage of the total monthly costs to the total costs for the preceding five-year period:

Month	1953 Average monthly cost per member: Amount	1953 Average monthly cost per member: Percent of cost for year	1953 Percent of monthly costs to total over prior 5-year period	1954 Average monthly cost per member: Amount	1954 Average monthly cost per member: Percent of cost for year	1954 Percent of monthly costs to total over prior 5-year period
January	$1.12	7.71	7.48	$1.12	7.62	7.46
February	1.10	7.57	7.47	1.27	8.62	7.34
March	1.24	8.52	8.54	1.37	9.27	8.44
April	1.32	9.15	8.83	1.24	8.41	8.82
May	1.28	8.84	8.97	1.35	9.18	8.83
June	1.32	9.12	9.03	1.41	9.56	9.07
July	1.35	9.28	8.90	1.34	9.12	8.93
August	1.23	8.52	8.58	1.24	8.41	8.67
September	1.19	8.22	8.15	1.20	8.16	8.26
October	1.19	8.19	8.20	1.17	7.95	8.42
November	1.06	7.29	7.56	1.10	7.49	7.65
December	1.10	7.59	8.29	.91	6.21	8.11
Total	14.50	100.00	100.00	14.72	100.00	100.00

The foregoing tabulation reflects the actual average cost to plaintiff in each month of the years involved for each member whose membership continued in effect. The difference between the costs incurred for servicing memberships that continued from the prior year and the membership fees collected in the prior year, but treated by plaintiff as a liability of the plaintiff at the end of the year and transferred to gross income in the current year, would, under plaintiff's system of accounting, represent the net income in the current year applicable to such memberships.

Conclusion of Law

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that plaintiff is not entitled to recover, and its petition is therefore dismissed.

[fol. 85]

IN THE UNITED STATES COURT OF CLAIMS.

[Title omitted]

MOTION FOR REHEARING AND FOR AMENDMENT OF FINDINGS OF FACT AND CONCLUSIONS OF LAW—Filed March 25, 1960

Comes now the plaintiff in the above described case and moves that this Court (1) grant a rehearing (2) amend its Findings of Fact and (3) alter its judgment for the reasons described below:.

1. The Court has stricken from its Findings of Fact a number of vitally important facts which were established by plaintiff's uncontradicted testimony and which were included in the Findings of Fact made by Commissioner Bennett who heard the testimony in the case, all of which Findings of Fact plaintiff respectfully requests this Court to restore.

2. The Court's present opinion is inconsistent with its Findings of Fact in that the opinion holds the plaintiff's method of deferral is "purely artificial" whereas Finding of Fact (22) states that plaintiff's method of deferral is in accordance with generally accepted accounting practices. This inconsistency becomes even more apparent if Com-
[fol. 86] missioner Bennett's Findings of Fact are restored. The Court's judgment should be altered to conform to the facts.

3. The decision in the case at bar is an improper extension of the decision of the United States Supreme Court in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, because plaintiff in the case at bar proved that its method of deferral was in accordance with generally accepted accounting practices which plaintiff in the *Michigan Club* case failed to do.

4. The Internal Revenue Code and Treasury Regulations do not permit the Commissioner of Internal Revenue to disturb a taxpayer's method of accounting if it is in accordance with generally accepted accounting practices. A

realistic deferral of income is permissible under the statutes, regulations and applicable Court decisions, and plaintiff has proved its method of accounting for prepaid dues income is both realistic and practical.

A brief in support of this motion is attached hereto and made a part hereof.

Wherefore plaintiff respectfully requests that a rehearing be granted in order that the Court's Findings of Fact may be amended and corrected, and that its judgment may be altered.

Respectfully submitted,

Fleming Bomar, Joseph E. McAndrews, Attorneys for Plaintiff, 306 Southern Building, Washington, D. C.

Of Counsel: Ivins, Phillips & Barker, Washington, D. C.

[fol. 87]

BRIEF IN SUPPORT OF MOTION FOR REHEARING

1. Plaintiff requests the restoration of the Findings of Fact as made by Commissioner Bennett.

The decision of the Court in the case at bar was based upon the ground that the issue had already been decided by the United States Supreme Court in *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180. It becomes exceedingly important, therefore, to have an accurate comparison between the facts established in the *Michigan* case and the facts established in the case at bar. Plaintiff therefore respectfully requests this Court to restore the Findings of Fact made by Commissioner Bennett who heard the testimony in the case, who had the opportunity of seeing and evaluating the expert accountants produced by plaintiff, and who determined that his Findings of Fact were "supported by the overwhelming weight of documentary evidence and expert testimony". Specifically, plaintiff

requests that the Findings of Fact made in the Report of [fol. 88] Commissioner Bennett filed July 16, 1959 be restored in their entirety and particularly in the following respects:

(a) With respect to the accounting principle which is in issue, Commissioner Bennett found, in Paragraph 23 of his Report, the following fact:

> "23. Under generally accepted accounting principles a distinction is made between a financing transaction and a revenue or income transaction. Funds received in a revenue or income transaction are reflected in the profit and loss statement of a taxpayer as gross income. This is not true in the case of funds received in a financing transaction. They are reflected in the balance sheet as liabilities.
>
> "Financing transactions involve ways and means of raising funds for business operations and may be grouped under three general types: (a) funds obtained from shareholders in exchange for stock; (b) funds obtained from banks or other lenders on notes, bonds or other evidence of indebtedness; and (c) funds obtained by advances from customers or members on open accounts, receipts or certificates of membership for future delivery of goods or services to be rendered in the future.
>
> "Funds representing advances from customers or members of an organization are not income at the time they are received but constitute a liability until such time as goods are delivered or services are rendered or made available in accordance with the advance payment agreement. It is an undisputed principle of accounting that no revenue or income can emerge until goods are delivered or until services are rendered.
>
> "Upon the prepayment of annual dues a member of the plaintiff corporation acquired a right to receive certain materials, information and services provided in the membership agreement over a 12-month period. Plaintiff's liability to such member cannot be completely discharged until the expiration of the membership period. Under generally accepted accounting

[fol. 89] principles, it is realistic and reasonable to recognize and transfer to gross income such prepaid dues ratably over the period of membership." [Paragraph 23].

(b) And with respect to the so-called method of accounting which the Commissioner of Internal Revenue forced upon plaintiff, Commissioner Bennett found as a fact that:

(1) " . . . This application of the receipt of funds as income is contrary to generally accepted accounting principles and practices." [Paragraph 24].

(2) " . . . the adjustments by the Commissioner of the Internal Revenue Service, reflects an overstatement of surplus for 1953 of $1,358,003.10, or approximately 54% in excess of the true surplus." [Paragraph 24].

(3) "By applying similar adjustments to plaintiff's balance sheet as of December 31, 1954, the surplus would be increased and overstated by $1,634,840.81, or approximately 99 percent, and would omit plaintiff's liability to members for a similar amount." [Paragraph 24].

(4) "The evidence establishes that reputable members of the accounting profession would not certify to the accuracy of the income statements and the balance sheets reflecting the adjustments by the Commissioner of the Internal Revenue Service." [Paragraph 24].

(c) With respect to the realistic and practical nature of the method of accounting used by plaintiff consistently since 1931, Commissioner Bennett found as a fact:

"The advance payment on a service contract, or any other type of contract, does not constitute income or revenue to the recipient, although the acceptance thereof creates a liability to perform. Under generally accepted accounting principles, the accounting for the funds received in advance must be recorded as a liability of the recipient. The plaintiff did this con-

sistently since 1931. These membership contracts entitled the members to receive membership services over [fol. 90] a period of 12 months from the date of subscription and acceptance. . . .

"The method of accounting employed by plaintiff was in accordance with accepted accounting principles. The assignment and transfer of funds from the prepaid dues account to revenue or gross income measured over the period of the membership contracts is found to be the most realistic method for properly recording gross income from dues." [Paragraph 25].

"On the evidence presented, the recognition and assignment of prepaid dues ratably over the period of membership is found to be the most realistic and practical method of accounting for gross income from membership dues." [Paragraph 29].

"The plaintiff's liability for servicing members whose membership continued beyond the current year when dues were paid was not a 'contingent' liability. It was a true liability and the costs were substantially in proportion to membership from year to year with reasonable constancy from month to month. . . . " [Paragraph 31].

(d) And in conclusion Commissioner Bennett made the following crucial Finding of Fact which plaintiff respectfully requests this Court to restore.

"33. The plaintiff's liability to members for that portion of their memberships which extended beyond the current year in which plaintiff collected the dues in advance is not gross income from membership dues because it was paid and received for a later year. Neither can it be net income in the year when the dues were received because the cost of servicing such memberships could not be performed until the following year when such net income would be realized.

"The method of accounting employed by the plaintiff during the calendar years 1953 and 1954 and prior years in keeping its books and records clearly reflected its net income for such years. The plaintiff's income

tax returns for 1953 and 1954 were prepared in accordance with the method of accounting employed in keep-
[fol. 91] ing its books and records and clearly reflected the net income for these years. This conclusion and the findings set forth above are supported by the overwhelming weight of the documentary evidence and expert testimony." [Paragraph 33].

(e) This Court in its Findings of Fact, in Paragraph 22, stated:

"22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices and was, prior to the adverse determination by the Commissioner of the Internal Revenue, customarily and generally employed in the motor club field."

Plaintiff respectfully requests this Court to strike the word "commercial" from the above described Finding of Fact and to strike out the phrase "and was, prior to the adverse determination by the Commissioner of the Internal Revenue, customarily and generally employed in the motor club field." There is no reference whatsoever in the record to commercial accounting principles as contrasted with generally accepted accounting principles. There is no reference in the record to the fact that any motor club, much less plaintiff, does not continue to keep its books and records in accordance with the only method of accounting which clearly reflects its income regardless of the position taken by the Commissioner of Internal Revenue.

2. The Court's present opinion is inconsistent with its Findings of Fact, and should be altered to conform to its Findings of Fact.

The Court has stated on page four of its opinion:

"The issue to be decided by this court is whether the Commissioner of Internal Revenue correctly determined that plaintiff's method of accounting—with respect to dues received from members of its divisions

> —does not clearly reflect plaintiff's income within the [fol. 92] meaning of §41 of the Internal Revenue Code of 1939 and §446 of the Internal Revenue Code of 1954."

On page five of its opinion the Court infers that the basis of its decision was that plaintiff's method of accounting is "purely artificial." However, the Court also states, on page six of its opinion, that the *Michigan Club* case did not expressly rule out deferral of income; and in its Finding of Fact (22) the Court states that the method of accounting used by plaintiff regularly since 1931 is in accord with generally accepted commercial accounting principles and practices and has been customarily employed in the motor club industry. These Findings of Fact and conclusions are wholly inconsistent. Commissioner Bennett's Findings of Fact which plaintiff has requested this Court to restore make this point even more clearly. Findings of Fact (26), (30) and (31) as made by this Court further show that the method of deferral employed by plaintiff was realistic since advance dues were reported as income over the same period of time that the costs of servicing members were incurred. Since the Court has found that the plaintiff's method of deferral is in accord with generally accepted commercial accounting principles, it would follow that if any system of deferral is allowable it would be the system used by plaintiff. By disallowing the use of plaintiff's method of deferral the Court is in effect holding that no method of deferral is permissible for motor clubs—an unwarranted extension of the doctrine of the *Michigan Club* case.

Since the Court has found as a fact that plaintiff's method of accounting is in accord with generally accepted accounting principles and since the sole purpose of accounting principles is to reflect income clearly, it is most inconsistent for the Court to conclude that plaintiff's method of accounting is "purely artificial." This is particularly true in view of the fact that neither the Commissioner of Internal Revenue nor the Court has suggested any method [fol. 93] of deferral although deferral is essential in order to reflect plaintiff's income accurately.

Accordingly the Court's opinion should be altered to remove the inconsistency which exists therein.

3. The decision of the Court of Claims in the case at bar represents an unwarranted extension of the decision of the United States Supreme Court in Automobile Club of Michigan v. United States.

In the *Michigan* case the method of accounting employed by the taxpayer was described by the Supreme Court as "artificial" and was held not to clearly reflect income for the reason, presumably, that the pro rata allocation of dues over the period of a membership "bears no relation to the services which petitioner may in fact be called upon to render for the member." 353 U.S. 180, at 189. In the *Michigan* case there was no accounting testimony of any kind, expert or otherwise. There was not even an adequate explanation of the method of accounting used by the Michigan Club. There was no proof of any relationship between the period of time over which advance dues of members were recognized as income and the period of time over which the costs of serving its members were incurred. There was no testimony to the effect that the Government's method of accounting was not in accord with generally accepted accounting principles and did not reflect accurately the income of the Michigan Club. The trial and appellate courts were left to speculate about these matters.

By contrast, in the case at bar there was uncontradicted and unassailable proof of the fact:

(a) That taxpayer's method of accounting was in accord with generally accepted accounting principles.

(b) That there was a precise and constant correlation between the period of time over which advance dues were recognized as income and the period of time over which [fol. 94] costs were incurred in serving its members—in other words, there was an almost exact matching of income and expense, which is the essence of accrual accounting.

(c) That the taxpayer's method of accounting with respect to prepaid dues income was realistic and was the most practical method of accounting which it could have employed.

(d) That the taxpayer's method of accounting clearly reflected its net income.

(e) That the Government's method of accounting is not in accord with generally accepted accounting principles and practices.

(f) That the Government's method of accounting results in an overstatement of plaintiff's surplus account of $1,358,003.10 in 1953, and an overstatement of surplus of $1,634,840.81 in 1954.

(g) That the Government's method of accounting for prepaid dues income does not reflect taxpayer's net income accurately.

(h) That no reputable certified public accountant would certify to the accuracy of plaintiff's profit and loss statements or balance sheets if the Government's method of accounting for prepaid dues is forced upon plaintiff.

This Court is therefore clearly extending the *Michigan* decision if it holds that the Commissioner of Internal Revenue has not exceeded the permissible limits of his discretionary authority when he changes the method of accounting of a taxpayer from one which reflects its net income clearly to one which does not.

4. A realistic deferral of income is permissible under the statutes, regulations and court decisions.

In its opinion in the case at bar the Court of Claims stated:

> [fol. 95] "... it would appear that Automobile Club of Michigan does not expressly rule out deferral of income...."

The United States Court of Appeals for the Second Circuit in *Bressner Radio, Inc.* v. *Commissioner*, 267 F. (2d) 526, which was decided after the *Michigan Club* case, stated this conclusion as follows:

> "It is apparent from the decision of the majority [in the Michigan case] that at least for purposes of the decision of the case it assumed that a realistic deferral

would have been permissible, and found only that no realistic deferral was made."

The statutory provision permitting a realistic deferral is Section 42 of the 1939 Code and Section 451 of the 1954 Code, both of which state:

> "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.*" (Emphasis supplied.)

The above quoted statute which this Court does not mention in its opinion is the sole authority for the Regulations issued by the Internal Revenue Service with respect to "long term building, installation or construction contracts." Regs. 1.451-3. If a builder receives a $25,000 advance payment in connection with a contract that extends beyond twelve months, the builder is not required to report the $25,000 as income until the contract is completed—if the completed contract method of accounting is elected—or pro rata as the building progresses, if the percentage of completion method of accounting is used.

Under the authority of the same statute the Commissioner of Internal Revenue, long before the *Beacon Publishing Company* case (218 F. (2d) 697), ruled that pub- [fol. 96] lishers could defer until the year of delivery prepaid subscription income. I.T. 3369, 1940-1 C.B. 46.

Under the authority of the same statute, the Commissioner of Internal Revenue has ruled that a travel bureau can defer reporting until the year in which the cruise takes place, advance payments made by customers to reserve space on the cruise. I.T. 2080, III-2 C.B. 48.

It would be exceedingly illogical if the same statute did not permit the realistic deferral of prepaid income received in connection with a service contract, or in connection with membership privileges where the costs involved will be incurred necessarily in the future.

How can the tax treatment of prepaid dues be distinguished from the tax treatment of prepaid magazine sub-

scriptions, prepaid income in connection with building, installation and construction contracts and prepaid cruise tickets? The United States Court of Appeals in *Bressner Radio, Inc.* v. *Commissioner, supra* (prepaid television service contracts), says they cannot, and it is respectfully submitted that the Second Circuit is correct. This Court is requested to alter its decision to reach the same result as that reached by the Second Circuit in the *Bressner* case. As a very minimum, this Court should restore the Findings of Fact of Commissioner Bennett so that the conflict between this Court's opinion and that of the Second Circuit will become apparent for purposes of Supreme Court review.

[fol. 97]

CONCLUSION

For the reasons above stated, a rehearing should be granted to give plaintiff an opportunity to present argument that the Court's opinion should be altered or amended.

Respectfully submitted,

Fleming Bomar, Joseph E. McAndrews, Attorneys for Plaintiff, 306 Southern Building, Washington, D. C.

Of Counsel: Ivins, Phillips & Barker, Washington, D. C.

[fol. 98]

IN THE UNITED STATES COURT OF CLAIMS

[Title omitted]

ORDER DENYING MOTION FOR REHEARING AND FOR AMENDMENT OF FINDINGS OF FACT AND CONCLUSIONS OF LAW—May 4, 1960

These cases come before the court on motions for rehearings, amendment of judgments or new trials under Rules 53 or 54 of the Rules of this court and, on consideration thereof,

It Is Ordered this fourth day of May, 1960, that said motions be and the same are overruled as follows:

274-54 New Jersey Automobile Club. Plaintiff's motion.
307-56 Herbert Rosengarten.
308-56 David Rosengarten. Plaintiffs' motion.
454-56 Concetta F. Stamer. Defendant's motion. Third party defendant's motion.
311-58 American Automobile Association. Plaintiff's motion.
356-58 Mary R. Palmer, Administratrix of the Estate of James C. Palmer. Plaintiff's motion.

[fol. 99]

411-58 Irving Dulcy. Plaintiff's motion.
429-58 Hugh N. Fleming, Jr. Plaintiff's motion.
548-58 Garrett L. Schuyler. Defendant's motion.
70-59 Sicanoff Vegetable Oil Corp. Plaintiff's motion.

By the Court

Marvin Jones, Chief Judge.

[fol. 100] Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 101]

SUPREME COURT OF THE UNITED STATES

No. 288, October Term, 1960

AMERICAN AUTOMOBILE ASSOCIATION, Petitioner,

vs.

UNITED STATES

ORDER ALLOWING CERTIORARI—October 10, 1960

The petition herein for a writ of certiorari to the United States Court of Claims is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

FILE COPY

SUPPLEMENTAL TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1960

No. 288

AMERICAN AUTOMOBILE ASSOCIATION,
PETITIONER,

vs.

UNITED STATES.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

PETITION FOR CERTIORARI FILED AUGUST 2, 1960
CERTIORARI GRANTED OCTOBER 10, 1960

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1960

No. 288

AMERICAN AUTOMOBILE ASSOCIATION,
PETITIONER,

vs.

UNITED STATES.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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[fol. 1]

IN THE UNITED STATES COURT OF CLAIMS

No. 311-58

AMERICAN AUTOMOBILE ASSOCIATION, Plaintiff,

vs.

UNITED STATES OF AMERICA, Defendant.

Washington, D. C.,
Monday, November 24, 1958.

Testimony for Plaintiff

The parties met, pursuant to notice of the Commissioner, at the time above stated, in Hearing Room No. 1, United States Court of Claims.

Present:

Hon. Marion T. Bennett, Commissioner.

APPEARANCES

Fleming Bomar, Esq., and Joseph E. McAndrews, Esq., Counsel for the Plaintiff.

William T. Kane, Esq., Counsel for the Defendant.

(The reporter, D. F. King, was first duly sworn by said Commissioner.)

[fol. 2] Commissioner Bennett: Gentlemen, we are prepared to hear the evidence in the case of the American Automobile Association against the United States. Plaintiff's counsel is recognized. Do you wish to make an opening statement?

Mr. Bomar: Yes, Your Honor.

First, Your Honor, we have here the agreed stipulation of facts which I offer for submission and the attached exhibits referred to in the stipulation.

Commissioner Bennett: The exhibits are in the folders?

Mr. Bomar: In the folders, yes, sir.

Commissioner Bennett: Without objection the stipulation and seven accompanying exhibits are received into evidence and may be marked as Joint Exhibits Nos. 1 through 8.

(Stipulation with seven attached Exhibits were marked Joint Exhibits Nos. 1 through 8 and received in evidence.)

OPENING STATEMENT ON BEHALF OF THE PLAINTIFF

Mr. Bomar: May it please the Court, Plaintiff is a membership corporation without stock of any kind and seeks a refund of a part of the Federal income taxes which it has paid for the calendar years 1952 and 1953. The calendar year 1954 is also involved in this proceeding because the Plaintiff incurred a substantial loss during the calendar year 1954, or, Plaintiff contends that it did, which gives rise [fol. 3] to an operating loss carryback deduction to the calendar years 1952 and 1953.

The Federal income taxes in issue total $195,277.81.

Only one issue is involved in this case and that is whether Plaintiff's method of accounting for prepaid dues received from members of its ten divisions, clearly reflects Plaintiff's net income. Plaintiff contends that its method of accounting is in accord with generally accepted accounting principles and clearly reflect its net income, and accordingly under the statute must be accepted for tax purposes. Under Plaintiff's method of accounting, dues paid in advance for twelve months by members of its divisions are not recognized as income entirely in the year of receipt but, instead, are recognized as gross income ratably over the period of time that Plaintiff is obligated to render services to its members, whether or not such period extends beyond the close of Plaintiff's taxable year. Plaintiff contends that prepaid dues are in advance from members which cannot be recognized as gross income until services are rendered, or made available.

The Commissioner of Internal Revenue has ignored Plaintiff's method of accounting and has substituted a method of his own under which all advance dues are recog-

nized as income in the calendar year of receipt, irrespective of the fact that Plaintiff is obligated to render services over [fol. 4] a period of time which extends beyond the close of Plaintiff's taxable year. Plaintiff contends that the method of accounting which the Commissioner seeks to force upon it does not clearly reflect its net income in any sense of the word.

Plaintiff claims that under Section 41 of the 1939 Code and Section 446 of the 1954 Code it is required to file its tax returns in accordance with the method of accounting regularly employed in keeping its books and records unless such method does not clearly reflect its income.

Plaintiff also contends that under Section 42 of the 1939 Code and under Section 451 of the 1954 Code, it is not required to report advance dues as income in the year of receipt, if under the method of accounting used in computing its taxable income, such dues are to be properly accounted for as of a different period.

Plaintiff claims that the United States Supreme Court decision in *Automobile Club of Michigan* versus *Commissioner*, reported at 353 U.S. 180, is not controlling, in so far as this proceeding is concerned, for a number of reasons.

First, the Supreme Court decision was a factual decision based exclusively upon the evidence before the Court in that case. It is evident that the decision was grounded only upon the facts, or lack of facts, in that case from the fol- [fol. 5] lowing quotation from the majority opinion of the Court, and it was a five to three decision on this issue, the majority opinion being written by Mr. Justice Brennan.

Quoting from Mr. Justice Brennan's opinion, he stated:—

Commissioner Bennett: What page?

Mr. Bomar: I have the Lawyer's Edition, Your Honor, and it is page 753. It is the final part of the Court's decision on the third issue involved in that case.

Mr. Kane: Your Honor, it is page 9 of the slip opinion.

Commissioner Bennett: I have the United States Reports, so we are all using three different volumes. I will find it.

Mr. Bomar: (Quoting)

"The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no rela-

> tion to the services which petitioner may in fact be called upon to render for the member."

And at that point a footnote appears in which the Court stated that:

> "Beacon Publishing Company, 218 F. (2d) 697, and Schussler v. Commissioner, 230 F. (2d) 722, were distinguishable on the facts because in Beacon, performance of the subscription in most instances was in part necessarily deferred until the publication date after [fol. 6] the tax year. In Schussler, performance of the service agreement required the taxpayer to furnish services at specified times in years subsequent to the tax year."

Then Mr. Justice Brennan continues:

> "Section 41 vests the Commissioner with the discretion to determine whether the petitioner's method of accounting clearly reflects income. We cannot say, in the circumstances here, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits."

Now, the following quotation from the dissenting opinion of Mr. Justice Harlan, concurred in by two members of the Court, also makes it abundantly clear that the Court did not apply the "claim of right" doctrine. In the last paragraph of his opinion, he states:

> "The Court, however, now by-passes the Commissioner's 'claim of right' argument and rests its decision instead on the ground that the 'pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may, in fact, be called upon to render for the member,' so that it cannot say that in doing what he [fol. 7] did the Commissioner exceeded the limits of his discretion. I do not understand this. . . ."

The Michigan case is also clearly distinguishable because Plaintiff in this case intends to establish the fact that there

is a direct relationship between the period of time over which prepaid dues are recognized as gross income and the cost of serving the members over such period of time. Proof of this fact, it is submitted, should establish that Plaintiff's method of accounting is not artificial.

Plaintiff also intends to establish that the method of accounting forced upon it by the Commissioner of Internal Revenue does not and cannot reflect its net income accurately and that the accounting profession is in complete agreement on this point. Plaintiff contends that if the Commissioner requires Plaintiff to pay income taxes in accordance with a method of accounting which does not reflect its true net income, the Commissioner has exceeded permissible limits of his discretionary authority.

The final ground of distinction is that the Michigan case involved the taxable years 1943 through 1947 which were governed exclusively by the provisions of the Internal Revenue Code of 1939. By contrast, the computation of the 1954 calendar year loss incurred by Plaintiff which gives rise to the operating loss carryback deductions claimed by [fol. 8] Plaintiff for 1952 and 1953 is governed by the provisions of the 1954 Code. The 1954 Code broadened the provisions relating to permissible accounting methods and the Senate Finance Committee Report explained Section 446 of the 1954 Code, stating as follows:

> "A method of accounting which reflects the consistent application of generally accepted accounting principles in a trade or business will ordinarily be considered as clearly reflecting income."

Plaintiff expects to establish the fact that its method of accounting is in accord with generally accepted accounting principles for motor clubs for the reason that under generally accepted accounting principles, advance dues cannot be recognized as gross income until services are rendered or made available to the member.

Finally, Plaintiff contends that if the evidence should reveal that there have been any changes during the years in issue in the procedures or mechanics involved in the computation of its Unearned Dues Liability account as of December 31st each year, and if any such change is contested by Government counsel, any such change, if material,

would merely constitute a Rule 38 (c) adjustment, and would have no bearing whatsoever on the single issue presented to the Court in this case, which is whether Plaintiff's [fol. 9] consistent method of deferring prepaid and advance dues is proper in order to clearly reflect its net income.

Commissioner Bennett: Mr. Kane?

Mr. Kane: Commissioner Bennett, I think he has stated the issues very well and, as he points out, our defense is based on the Supreme Court Decision in Automobile Club of Michigan, 353 U.S., 180. I believe all the questions that are in issue here today were considered by the various courts in that proceeding and I think it is really a legal issue as to whether or not they were, and that would be our basic position. I am not making any legal arguments here this morning.

Commissioner Bennett: You may call your first witness, Mr. Bomar.

Mr. Bomar: Mr. Blum, please.

Whereupon—FREDERICK M. BLUM, a witness produced on behalf of the Plaintiff, being first duly sworn by said Commissioner, was examined and testified as follows:

Direct examination.

By Mr. Bomar:

Q. Please state your name, address and occupation.

A. My name is Frederick M. Blum. I reside at 4412 [fol. 10] Springdale Street, N.W., City of Washington, D. C. I am auditor of the American Automobile Association.

Q. How long have you served as auditor of the American Automobile Association?

A. Since 1931.

Q. Please describe your duties as auditor.

A. I am in charge of the Accounting Department of the Association. My work in that capacity is primarily responsible to management for accounting and record preparation of financial statements and interpretations thereof and related accounting functions such as procedures, methods, budgets, tax matters, et cetera.

Q. Are you a Certified Public Accountant?

A. I am.

Q. In which state or jurisdiction did you receive your certificate?

A. I received my certificate in 1929 from the District of Columbia, and also from the State of North Carolina.

Q. Mr. Blum, have you read and are you familiar with the facts alleged by the American Automobile Association in its petition in this case, as well as the Government's answer and agreed stipulation of facts?

A. I have and I am.

Q. Let me direct your attention to Paragraph 7 of Plain-
[fol. 11] tiff's petition, which describes in very general language the method of accounting followed by the American Automobile Association with respect to the recognition of advance dues as income. How long has this method of accounting been employed by the American Automobile Association?

A. It has been employed ever since I was employed as auditor, for the past 27 years.

Q. And, Mr. Blum, since you have been auditor of the American Automobile Association has the Association ever followed a method of accounting which recognized the advance dues received from members of its divisions as income entirely within the year of receipt?

A. No, it has not.

Q. Why not?

A. Because that does not, in my opinion, properly—

Mr. Kane: I object to the question and answer as a conclusion.

Commissioner Bennett: Are you offering him as an expert on this, Mr. Bomar?

Mr. Bomar: He is a Certified Public Accountant, Your Honor, with many years of experience. We are dealing with the subject of a method of accounting which seems to me peculiarly within the competence of an accountant.

Commissioner Bennett: Does defense counsel wish to
[fol. 12] examine him on his qualifications?

Mr. Kane: I will agree that he is a certified public accountant, but I don't believe he has been qualified as an expert by the petitioner here.

Mr. Bomar: Without qualifying him as an expert I was merely asking for a factual reason as to why the books and records are kept in accordance with this method of accounting.

Mr. Kane: If he wishes to answer, why, I won't object. I object to the conclusion on the part of this witness without the proper background.

Commissioner Bennett: You may restate your question to satisfy counsel.

By Mr. Bomar:

Q. Why, Mr. Blum, in keeping the books and records of the Association, did you not use a method of accounting which recognized the advance dues as income in the year of receipt?

A. Because that is not in accordance with good accounting principles.

Q. In what year was the American Automobile Association first required to file—

Mr. Kane: Would you have him explain that answer so we will have it all at this point?

Mr. Bomar: I think that is proper, sir, in cross-examina-
[fol. 13] tion.

Mr. Kane: Fine. Thank you.

By Mr. Bomar:

Q. In what year was the American Automobile Association first required to file a Federal income tax return and to pay a Federal income tax?

A. 1943.

Q. Was the method of accounting described in Paragraph 7 of Plaintiff's petition in this case used in keeping its books and records and filing its Federal income tax returns in 1943?

A. Yes.

Q. Was the method of accounting which you have described used both before and after the Plaintiff was taxable?

A. Oh, yes, it has been used since 1931.

Q. When did the Internal Revenue Service first rais-

any question in an official communication to the American Automobile Association with respect to its method of accounting?

A. That was in April of 1954 upon receipt of a thirty-day letter assessing deficiencies for the years 1950, 1951 and 1952.

Q. Was the Association required to pay those deficiencies?

[fol. 14] A. No, they were not.

Q. When was the Association first required to pay Federal income taxes on the basis that advance dues should or must be recognized as gross income entirely in the year of receipt?

A. 1953 and for the years subsequent.

Q. Who were the independent certified public accountants for the American Automobile Association during the years in litigation?

A. Ernst & Ernst.

Q. How long had that firm served as your independent Certified Public Accountants?

A. Since the year 1931.

Q. Mr. Blum, will you please illustrate to the Court as simply as possible the method of accounting used by the Club with respect to the recognition of advance dues as gross income? For example, let's assume that the member pays dues of $12 in advance for services to be rendered over the ensuing twelve-month period, how does the American Automobile Association account for the $12 of advance dues?

A. Well, that would depend upon the method in which those dues were received. If we received those advance dues or prepaid dues in the month of January then we would pay one-twenty-fourth of the amount as earned income during [fol. 15] January, one-twelfth each ensuing month, then when he reached December 31st the remaining 1/24th would constitute a liability as of the end of the year. If on the other hand those dues were received in December, only 1/24th or 50 cents would be taken up as earned revenue and the other 23/24ths, or $11.50, would be a liability as of the end of the year.

Q. Mr. Blum, I would like to direct your attention to

Paragraph 8 of the agreed stipulation of facts which sets forth the amount of dues on a monthly basis, which the records of the Automobile Association show as having been received during the calendar year 1953. I also call your attention to Paragraph 10 of the agreed stipulation which states that out of $3,531,178.67 of dues recorded on the books as having been received in 1953, the sum of $1,755,407.46 was not recognized as gross income during the calendar year 1953 but remained in a liability account at the end of the year. How was this sum of $1,755,407.46 computed?

A. It was computed by the method I have just mentioned, namely, of going back to the January figure, 1/24th of that constituted a liability at December 31st, 3/24ths of the February figure, and so on, and a computation of that will arrive at $1,755,407.46.

Q. Mr. Blum, have you computed at my request the [fol. 16] percentage of the total advance dues recorded on the Plaintiff's books in the calendar year 1953 which were recognized as gross income in 1953 as contrasted with the percentage which remained in a liability account as of the end of the year?

A. I have.

Q. And what are those percentages?

A. The proportion of the advance dues received taken into earned revenue was 50.3 per cent and the amount of liability was 49.7 per cent.

Q. Now, Mr. Blum, I call your attention to Paragraph 13 of the agreed stipulation of facts which shows on a monthly basis the advance dues received from members of the divisions during the calendar year 1954. What percentage of those advance dues was recognized as gross income in 1954 and what percentage remained in the liability account for deferred or unearned dues as of December 31, 1954?

A. 50 per cent is reflected as earned revenue and 50 per cent as earned revenue at the end of the year.

Q. Under the method of accounting employed by the American Automobile Association, have all expenses paid or incurred during a particular taxable year been deducted in the taxable year paid or incurred?

A. No, they have not.

[fol. 17] Q. Which expenses were not deducted in the year paid or incurred?

A. The prepaid membership costs were pro rated on the same basis as the advance or prepaid dues.

Q. And why were they not deducted even though they were paid or incurred?

A. Because the expenditures were made at the time of the receipt of the dues and covered the same period of time for which the membership was applicable, and, therefore, the expenses were spread over the same period.

Q. What items does your accounting department consider to fall in the classification of prepaid membership costs?

A. The commissions paid to the membership representatives at the time they obtain the membership and the payments which are made for personal accident insurance policies covering the period of a year for the same period of the membership.

Q. Mr. Blum, you have stated that you are the manager of the American Automobile Association Accounting Department with the title Auditor. Approximately how many persons were employed in this department during the calendar years 1953 and 1954?

A. There were approximately 70 persons.

Q. With a staff this large operating the various ac- [fol. 18] counting functions, do you directly handle the preparation of financial data, technical operating problems, et cetera?

A. No, I do not. I am responsible to management for the proper operation of the department, but the technical matters and the detailed operations have been delegated to my assistant, Mr. Arthur I. Cooper, who also is a Certified Public Accountant.

Mr. Bomar: Thank you, Mr. Blum. Your witness.

Cross examination.

By Mr. Kane:

Q. Mr. Blum, you in your direct examination stated that the first year in which there was a dispute as to the method

of accounting used was prior to 1953. I believe 1952 was involved in that dispute, as I recall it 1949 through 1952.

A. I think it was 1950, 1951 and 1952. You may be correct.

Q. Roughly it was those years. And you said that the method was acceptable at that time. Was it accepted as a result of a compromise settlement between yourself and the staff whereby you gave up your claim for exemption and they in turn allowed you this method of accounting, or do you know?

A. Well, I know it was a result of a compromise settle- [fol. 19] ment. As to giving up any right of claim or anything for exemption, I wouldn't want to answer that. I think that's something someone else would probably know better than I.

Q. You did not participate in these conferences?

A. No, only on the staff level.

Q. The staff level is where this particular matter—

A. I mean our staff, not the Internal Revenue Service.

Q. You are familiar that during the time this settlement was made that there were two sections of the Code then in effect, 452 and 462 of the Revenue Code of 1954 which were subsequently eliminated by Congress?

A. Yes.

Q. And that these sections specifically provided for relief in prepaid income cases?

A. That's my understanding.

Q. That is my understanding, too. I don't have the books here.

A. I have to answer that on the general basis. I don't know that I am qualified to answer that.

Q. I just said generally because we are both quoting from Section 452 and will quote from 452 in our briefs and requested findings.

You also gave testimony that, as alleged in Paragraph 7 [fol. 20] of the petition, you followed the consistent method of accounting throughout the years from 1931 right through at least the years in suit and to date, as far as I understand it. Isn't it true that there was a change in 1954 in your method, at least a change in your procedure or method as to how you pro rated the membership income in 1954 as opposed to 1953?

A. Yes, sir, there was.

Q. Will you explain that for the record, Mr. Blum?

A. During the year 1954 we were having our procedures reviewed and surveyed and a recommendation came to my desk that without changing the basic principle of properly reflecting income and the proper liability at the end of the year, that we were going to an awful lot of detailed work internally in computing a lot of figures and that we could arrive at the same result by pro rating our dues each month on the basis of taking up of the prepaid dues for that month 50 per cent into earned revenue and 50 per cent to be set aside as a liability.

We made various tests and I am sure our outside auditors did also, because we were in session with them on this point and we found differences.

I think I gave, in direct examination, for 1953 on this rather lengthy process that we followed, the earned revenue was 50.3, the liability was 49.7, and here we come up with a [fol. 21] 50-50 basis. It saved a great deal of internal work and we accepted that on recommendation, in changing of our principle of properly stating our earned dues and the proper liability.

Q. Didn't it go farther than that, Mr. Blum, that before 1954 you actually took into account on an accrual basis the income which was due rather than actually received?

In other words, to simplify it, if I signed a contract with you for $15 but did not pay the entire $15, you still put on your books $15 as of the receipt of my contract?

A. Yes, we did that prior to 1954.

Q. And then in 1954, instead of following that method or procedure, you only put on your books the $5 payment or the $10 payment as I actually sent them into your office?

A. That is correct.

Q. Now, the second change in method or procedure which occurred in 1954 involved, as I recall it, the question of treatment of commissions to salesmen and the overwrite to the manager, the overwrite being his commission to a certain extent; is that correct?

A. That, of course, has nothing to do with prepaid dues or advance dues. That is an expense factor and we did make a change during the year 1954 with respect to those expenses.

[fol. 22] Q. And would you explain that change for the record?

A. Yes. It was brought to my attention again, resulting from this survey and my own staff as well as our outside public accountants, that we had an inconsistency on our records in that some persons were paid a straight salary, which, of course, was the expense of that year, and other persons in identical capacity received a very small stated salary, and the rest of their compensation came from what we call overwrite, namely, certain amount per membership produced. In other words, we might have one manager of a division—and I am merely using figures here—getting $12,000 a year as a straight salary, we have another manager getting $3,000 a year as a straight salary and getting another $6,000, $7,000 or $8,000 as an incentive based on membership, both items being compensation in the final analysis. We had previously pro rated those overwrites. We realized that that was not good accounting and we made the change.

Q. You had pro rated the overwrite but not the salary?

A. That's right.

Q. Was that also true as far as the salesmen were concerned, if you can recall?

A. I know what you are referring to now. Yes, we would employ new salesmen, and for a short period of time, be-
[fol. 23] cause I think it is pretty well generally realized that in any general sales field it is difficult to employ people just on a straight incentive basis. We would say to a new employee we would guarantee that employee, let's say, $300 a month for, say, six months as the case might be. We considered that on our records at one time the same as being commissions. We realized that that was not an accurate statement, and in 1954 we computed the earnings based upon members produced times what that individual was supposed to get per member, and then if there was a difference we considered it to be a salary, under a guaranteed salary, training expense set-up.

Q. Then you deducted that in full for 1954?

A. The remaining, that's right.

Q. Did you defer any expenses after 1954?

A. I don't understand your question.

Q. Any salesmen expenses or commission expenses?

A. The commissions?

Q. After 1954, too.

A. Oh, yes.

Q. But not the overwrite?

A. Not the overwrite nor guaranteed salaries.

Q. Nor guaranteed salaries. You mentioned a personal accident insurance policy.

A. Yes, sir.

[fol. 24] Q. These personal accident insurance policies are mentioned in the first paragraph of our stipulation. Now, each member gets that personal accident coverage with his membership for a year?

A. That's right, for a period of his membership.

Q. For the period of his membership. And that is the other item that you had previously deferred as a membership cost?

A. That's right.

Q. How do you handle that personal accident insurance, do you actually have an insurance company of your own?

A. No. That is under contract with an insurance company which issues a master policy to the organization under which individual certificates may be issued to the members. I think the use of the words "personal accident insurance policy" for the individual is a misnomer. It is a certificate under a master policy and I think it is a general practice in other group fields where a master policy is issued and then individual certificates can be issued under the master policy.

Q. You get a group policy rate?

A. That's right.

Q. At the end of a year would you normally have something coming back from the premiums, or would you know?

A. That is possible, yes, under the contract. If the loss [fol. 25] ratios are quite satisfactory there can be a repayment at the end of the year.

Q. And that goes where, to the individual member or to the organization?

A. Oh, no, that goes back to the organization.

Q. Into its general fund?

A. That's right, taken up as revenue at that time.

Q. Now, I would like to ask you a few questions about how this money is handled, or would you prefer that I ask that of Mr. Cooper? It is immaterial.

A. He knows the detail probably better than I do, but it is up to you.

Mr. Kane: I will have no further questions of Mr. Blum at this time, but could we keep Mr. Blum around?

Mr. Bomar: Yes.

Mr. Kane: Thank you.

Redirect examination.

By Mr. Bomar:

Q. Mr. Blum, you stated that the American Automobile Association was engaged in prior litigation; is that correct?

A. On this subject?

Q. Not on this subject.

A. Not on this subject, no.

Q. What years were involved in the prior litigation?

[fol. 26] A. Are you speaking of the original litigation or the exemption question?

Q. Exactly.

A. The years of 1943, 1944 and 1945 and the carrybacks for 1946 and 1947.

Q. What method of accounting was used by the American Automobile Association during those years in litigation?

A. The same method which I heretofore described.

Q. Was any issue raised in that litigation with respect to the accuracy or the propriety of your method of accounting?

A. None at all.

Q. Mr. Blum, you have stated that in the year 1954 there were certain changes made in the mechanics of computing that proportion of dues received during a year which were recognized as income or revenue and in that proportion which were still considered to be a liability as of the end of the year. Have you, at my request, prepared a schedule from your financial statements and tax returns showing the proportion of dues received during the five years prior to the years in litigation or during the years 1949 through

1953 which shows total dues recorded on the books as having been received and the proportion of the total dues which were not recognized as gross income during the year?

[fol. 27] A. That is correct, sir.

Q. Is this the schedule?

A. Yes, that is it.

Mr. Bomar: I offer to present it in evidence as Plaintiff's Exhibit No. 8.

Commissioner Bennett: I have marked the others as joint exhibits since they were stipulated. Shall we make this one Plaintiff's Exhibit No. 1?

Mr. Bomar: Yes.

Commissioner Bennett: Has the Government counsel seen a copy of this?

Mr. Kane: I have seen it, Your Honor.

Commissioner Bennett: Is there any objection?

Mr. Kane: I have no objection, Your Honor. I would like to ask him a question about it, however.

Commissioner Bennett: If there is no objection it will be received as Plaintiff's Exhibit No. 1 in evidence.

(One-page document showing prepaid dues received, deferred revenue membership dues, and percentage, for the years 1949 through 1953 was marked Plaintiff's Exhibit No. 1 and received in evidence.)

By Mr. Bomar:

Q. Mr. Blum, during the calendar year 1949 what percentage of prepaid dues was recognized as revenue or income and what percentage of prepaid dues was considered [fol. 28] to constitute a liability as of the end of the year?

A. The liability at the end of the year was 50.1 per cent, and the revenue, then, would be 49.9 per cent.

Q. And in 1950?

A. The percentage was exactly 50 per cent.

Q. And in 1951?

A. The liability at the end of the year would be 49.8 per cent. The revenue taken up during the year, therefore, would be 50.2 per cent.

Q. And in 1952?

A. The liability is 49.4 per cent, and the earned revenue taken up, therefore, would be 50.6 per cent.

Q. Mr. Blum, in your opinion was any change in accounting practices connected with accounts receivable during the calendar year 1954?

A. I don't know that I understand your question, sir.

Q. On cross-examination you explained to Mr. Kane that during the calendar year 1954 a change in procedures was involved in so far as new members are concerned and that instead of regarding money as having been received on your books, when a new member signed an application to become a member of your organization he waited until the cash came in from the member. Can you explain from an accounting point of view why that change was made? [fol. 29] A. I think I can. It was brought to my attention that when we set up this portion of receivables on our record, and I guess it was understood or known that these are not the only receivables which we carry on the books, because at the end of 1953 and 1954 we had something like a half million dollars receivables on the books, but with respect to this relatively small amount and very small individual items, it was brought to my attention first, if I can remember the various points, but one would be that at the time we set up this receivable we were in effect at the same time setting up a liability, because we did not consider that dues were properly earned when received. Therefore, in effect, when we set this receivable up we were also in effect setting up a liability, so there we have a counterbalance item.

Secondly, we did not actually follow through with any legal rights on these items by forcing collection. If an individual didn't pay at the end of 65 days we just cancelled and offset the figure on our books, and, taking into consideration the very small amount involved, I believe at the end of 1954 the amount was about $44,000, and against which we would have an obligation to our salesmen of about $9,000, and considering all of those factors and the multiplicity of $5 and $10 items involved, it did not change our method of accounting, just to eliminate those and not con- [fol. 30] sider them as assets as such but carry them as memoranda accounts, which we did.

Q. Mr. Blum, in connection with the $44,000 receivable items which you mentioned, I am not sure that I understand the nature of the offset. Would the entire $44,000 be recognized as income or revenue, or would a portion of it be considered not to be revenue until services were rendered?

A. I thought that was explained. When we set up a receivable it was offset by a liability, so we took off proportionately on the receivables, and, therefore, we are talking about a very minor figure.

Q. For the calendar year 1954 did the American Automobile Association continue to defer as a deduction or spread as a deduction over the entire period of a membership those items which your Accounting Department considered to be truly prepaid membership costs?

A. Yes, we did continue that.

Q. And what items were continued to be spread? What items which you had paid did you not claim a deduction for except on a pro rata basis?

A. The Commissions paid to salesmen and the amounts paid the insurance company for personal accident insurance certificates.

Mr. Bomar: That is all.

[fol. 31] Recross examination.

By Mr. Kane:

Q. Then, I take it from your last answer that the other expenses connected with memberships were deducted as they accrued or were paid under your method of accounting?

A. All other expenses of the organization?

Q. Of the organization. For members, to service the members, any type of that kind were either approved or paid in the year billed?

A. As incurred, yes.

Q. This Plaintiff's Exhibit No. 1 which you prepared, just to make the record clear for me, you included in the prepaid dues received on a basis, as I recall it, of 1/24th of the first month, 1/12th for the next 11 months, and 1/24th again in the 13th month?

A. That is correct.

Q. You took up 1/24th of the accounts receivables whether it was actually paid with the membership or was to be paid in installments; is that correct?

A. In those years the amounts of accounts receivables would be included. Let's say for the year 1953 I think we had some $30,000 as a part of this $3,531,000, this accounts receivable figure.

Q. At the end of the year?

A. That's right.

[fol. 32] Q. But starting with January and going to December, as time went on, what you started out with as an accounts receivable in January would normally be paid in March?

A. That's right.

Q. Within 60 days?

A. That's right. And, therefore, the only amount involved in this would be the $30,000 paid at the end of the year.

Q. That is what I wanted to make clear for the record.

Now, the second question, I think you or Mr. Bomar said new members in this 1954 change, whatever the procedure or method was, as I recall it, it was not only a change for new members but for the members whether they were new or renewing their past memberships, it was still the same, you started picking up as they paid them rather than as you billed them?

A. Are you talking about receivables, sir?

Q. No, the 1954 method. I am sorry. The receivables in 1954, when Mr. Bomar, I believe, said you adopted a change in procedure or method for new members whereby you only took up what they actually paid. I want to ask only one question. Didn't this also apply to renewal of old members?

A. Only, you might say, now and then very, very few, [fol. 33] because on the renewals it has been the policy of the organization, and still is, to send out the renewal information, billing, in some cases the credentials, and no record is made on the books nor ever has been made on the books until payment was received. There might be some few exceptions to that, but they would be few and far between. Basically your billing is for new members and not renewals.

Q. For renewals you always waited until you received the money?

A. That's right.

Mr. Kane: Thank you. I don't think I have any more questions of Mr. Blum. Thank you very much.

Commissioner Bennett: You may step down. Thank you.

(Witness excused.)

Mr. Bomar: Mr. Cooper, please.

Whereupon—ARTHUR I. COOPER, a witness produced on behalf of the Plaintiff, being first duly sworn by said Commissioner, was examined and testified as follows:

Direct examination.

By Mr. Bomar:

Q. Please state your name, address and occupation for the record.

A. My name is Arthur I. Cooper. My residence is 7229 [fol. 34] Garland Avenue, Takoma Park. I am assistant auditor of the American Automobile Association.

Q. How long have you been employed by the American Automobile Association?

A. I was employed on April 6, 1953 as assistant to the auditor and I was made assistant auditor on April 29, 1954.

Q. Please describe briefly your educational background and experience.

A. I received a Bachelor of Arts Degree from Johns Hopkins University in 1943. I am a Certified Public Accountant of the State of Maryland, having received my certificate in 1951. Prior to joining the American Automobile Association I spent five years in public accounting practice in Hagerstown, Maryland.

Q. Please describe briefly your duties as assistant auditor of the American Automobile Association.

A. As immediate assistant of the auditor I am responsible for the day to day operations of the Accounting Department, including the maintenance of the general

ledgers and books and records of the American Automobile Association and its ten divisions.

Q. Mr. Cooper, have you read the petition filed by the American Automobile Association in this case, as well as the Government's answer and the stipulation of facts?

[fol. 35] A. Yes, sir, I have.

Q. Mr. Cooper, describe briefly what accounting records are under your supervision and are maintained in so far as the divisions of the American Automobile Association are concerned.

A. We keep separate ledger accounts for each of the ten divisions, which show the income and expense by division. From these general ledger records our monthly financial records are prepared.

Q. Who has the responsibility for maintaining the accounting records for the divisions?

A. The accounts and records are actually kept by personnel of the Accounting Department under my direct supervision.

Q. Have you prepared at my request a schedule which shows the total expense by months paid or incurred by all divisions of the American Automobile Association for the five-year period prior to 1953?

A. I have.

Q. And from what source was this schedule prepared?

A. The schedule was prepared from our regular monthly financial statements which are produced for the information of headquarters management and the managers of our division.

Q. And are those records available in the courtroom?

A. Yes, sir, they are.

[fol. 36] Q. Are these the schedules?

A. Those are the schedules.

Q. And would you explain briefly what appears in the next-to-the-last column of this schedule?

A. The next-to-the-last column represents the total expenses over a five-year period by month, that were incurred by our division operations. It includes all of the expenses of all ten divisions.

Q. Are these the costs involved in serving all of the members on a monthly basis during the five-year period?

A. Yes, sir, they are.

Q. And would you kindly explain the last column in the schedule?

A. The last column shows the percentage, the average percentage over a five-year period that the expenses were incurred by months. For example, for January, over a five-year period, we actually incurred expenses amounting to $824,652.89. For the entire five-year period the expenses were $11,021,870.54. The percentages shown in the last column were derived by dividing the expenses by months by the total for the five-year period, thus indicating the proportion of expenses on the average over a five-year period that were incurred by months.

Q. Mr. Cooper, was this schedule prepared by records maintained in the ordinary course of your business?

[fol. 37] A. Yes, sir, they were prepared from our regular general ledger records and financial statements that are prepared on a regular monthly basis for the information of management.

Mr. Bomar: Your Honor, I offer this schedule in evidence as Plaintiff's Exhibit No. 2.

Mr. Kane: No objection.

Commissioner Bennett: Received.

(One-page sheet showing monthly costs and expenses, five years 1948-1952, divisions only, was marked Plaintiff's Exhibit No. 2 and received in evidence.)

By Mr. Bomar:

Q. Mr. Cooper, have you, at my request, prepared a schedule which refers to the prepaid or advance dues shown as having been received by the American Automobile Association from its divisions in the calendar year 1953, in accordance with the agreed stipulation, and which schedule also recognizes as gross income or revenue a proportionate part of advance dues in proportion to the five-year historical costs?

A. Yes, I have.

Q. And is this the schedule?

A. This is the schedule that I prepared.

Q. And was the information obtained in this schedule prepared by you or under your supervision?

[fol. 38] A. It was.

Q. Now, Mr. Cooper; if instead of a pro rata allocation of dues or if instead of recognizing advance dues as income on a time basis as services are rendered or made available, advance dues had been recognized as income in proportion to the average cost of serving a member during the preceding five years, what proportion of the 1953 dues recorded on your books as having been received in 1953 would have been reflected in income in 1953 or would have been recognized as revenue, and what proportion would remain in the liability account as of December 31, 1953?

A. As shown in the exhibit, the next-to-the-last column shows a total of $1,778,627.57, which would have been included in our income account for the year 1953 out of a total of $3,531,178.67.

If I may just explain the schedule, the first column shows the amount of dues received by month during the year 1953, and totals $3,531,178.67.

Across the top of the schedule we have shown the monthly percentages that were determined in Plaintiff's Exhibit No. 2 as applicable over the five-year period and shown the percentage of costs determined by months during the preceding five-year period. We have then applied these percentages to the monthly dues and have shown as income by month the appropriate proportion of the monthly dues [fol. 39] received. For example, in January of 1953 we received dues in the amount of $257,698.02.

Because these dues are received during the entire month on different days we have assumed that approximately one-half the dues would be received in the month of January. Therefore, we show as income one-half of the amount of dues received, multiplied by 7.48 per cent, resulting in income in January of $9,637.90. Then we have applied the percentages indicated to that same January dues figure of $257,698.02, resulting in the income allocated to each of the months.

The total for the year 1953 that would be recorded in income out of the January receipts on this basis would be $248,060.11, and the amount that would be recorded as a

liability for unearned dues as of December 31, 1953, would be $9,637.91.

Q. Mr. Cooper, I call your attention to Paragraph 10 of the agreed stipulation of facts, which states that in accordance with the method of accounting actually used by the Association, the sum of $1,755,407.46 out of all dues recorded as having been received in 1953, remained in the liability account as of the end of 1953. How does the method which you used compare with the method of accounting which would have recognized the advance dues as income as expenses when incurred on an historical basis?

A. By reference to the last column to the right on Ex- [fol. 40] hibit No. 3, you will see that the liability given as of December 31, 1953 shows $1,752,551.10, which is our liability computed on the basis of the preceding five-year cost experiences. This compares with the $1,755,000 figure which you read from the stipulation.

Mr. Bomar: Your Honor, I offer that schedule in evidence as Plaintiff's Exhibit No. 3.

Mr. Kane: I object to that schedule being received in evidence on the basis that it is Government's position that it is irrelevant and immaterial to this case. We do not agree in essence that the Supreme Court was not aware that there was a deferment of membership dues and they had exactly the same facts presented to them. They decided this case adversely to the Plaintiff.

This statement quoted in the Supreme Court decision on which the Plaintiff appears to be relying here today, we don't believe is a basic reason for the Supreme Court's decision that if there had been a relationship between the cost of services pro rated and that type of evidence had been put into the record, that the Supreme Court's decision would have been any different. We believe that the minority opinions in this Supreme Court decision show clearly that the Court considered the fact that the income was taken into account this year and that there would be expenses connected with those new memberships during the [fol. 41] following year, and we believe that a showing of this type is irrelevant to the proper decision of the legal issue in this case.

Mr. Bomar: Your Honor, the decision in the Supreme Court case of Automobile Club of Michigan was grounded upon the fact that there was no proof of the fact that the pro rata allocation of dues on a monthly basis had any relationship to the services which the Plaintiff called upon the Club to render, and that that ordinarily relates it to the cost of service that Plaintiff was called upon to render.

We have examined the record in the Michigan Auto Club case and would be delighted to have it introduced as a part of the record in this case if it becomes material as to what evidence was produced in that case, or the lack of evidence, but certainly we contend in our case we have a right to approve what the facts are and to accrue the deficiency which the attorneys for the Plaintiff in that case apparently failed to substitute the missing facts which were not shown in the Michigan case.

Commissioner Bennett: Objection overruled. Plaintiff's Exhibit No. 3 is received.

Mr. Kane: May I have an exception, Your Honor?

Commissioner Bennett: Yes. I should have stated that both of you may have an automatic exception to any ruling I make, so you won't have to state it on the record.

[fol. 42] (Document entitled "Deferred Revenue—Membership Dues at December 31, 1953 Based on Cost Percentages for Five Years 1948 to 1952," was marked Plaintiff's Exhibit No. 3 and received in evidence.)

By Mr. Bomar:

Q. Mr. Cooper, the two schedules which have been introduced as Plaintiff's Exhibits Nos. 2 and 3 relate entirely to the calendar year 1953. Have you, at my request, prepared a schedule which shows the total cost incurred by months for all divisions of the American Automobile Association for the five-year period preceding the calendar year 1954?

A. I have.

Q. And is this the schedule?

A. Yes, sir, this is the schedule.

Q. And would you explain this schedule?

A. This schedule was constructed on exactly the same

basis that the preceding schedule labeled Plaintiff's Exhibit No. 2 was.

Q. Was it constructed from information obtained from the same accounting sources?

A. The information was obtained from the same sources, yes, the monthly costs represent the total costs of our divisions for the months and years in consideration, namely, the years 1949 through 1953.

[fol. 43] Q. What is the difference between this schedule and Plaintiff's Exhibit No. 2?

A. The difference solely is that it covers the years 1949 through 1953, whereas Exhibit No. 2 covered the years 1948 through 1952.

Q. And have you, at my request prepared an exhibit comparable to Plaintiff's Exhibit No. 3 except that it pertains to the calendar year 1954?

A. I have.

Q. And is this the schedule?

A. This is the schedule.

Q. And will you explain the schedule?

A. The schedule was prepared in the same fashion that Plaintiff's Exhibit No. 3 was prepared. It shows in the left-hand column the amount of prepaid dues received by month for the year 1954 and which is also, I believe, shown in the stipulation of facts in this case.

Across the top of each column we show the percentages which were computed and are shown on Exhibit No. 4 and which represent the proportion of expense incurred by month over the preceding five-year period. These percentages, then, were applied in the same way as in Exhibit No. 3 to the monthly dues. For example, for January 1954 we received dues in the amount of $290,764.23. Again assuming that these dues were received evenly throughout [fol. 44] the month of January, we applied the percentage of 7.46 per cent to one-half the dues received in January, resulting in an allocation to January 1954 of $10,845.50. Then the percentage is shown for each month at the top of the page, 7.34 per cent for February, for example, 8.44 per cent for March and so on we applied to the $290,764.23, resulting in the figures shown in each column across the sheet.

These figures were then added, and in the next-to-the-last column to the right we show as income in 1954, $279,918.73 out of the total received for January 1954, of $290,764.23.

This leaves a liability at December 31, 1954 to cover the cost of rendering service to the members who will be on the records at the end of January 1954 and who were actually placed on the records on January 1953, in the amount of $10,845.50.

Q. Mr. Cooper, if during the calendar year 1954 the advance or prepaid dues recorded on the books and records of the Association as having been received in the calendar year 1954 were recognized as income or revenue in proportion to the historical cost of serving a member on a monthly basis, of the proportion of dues received in the calendar year 1954, would have been recognized as gross income of the Association and what proportion would remain in the liability account as of the end of 1954?

[fol. 45] A. Of the total dues received in 1954 of $4,078,529.17 we would have shown on a five-year average cost basis $2,070,078.69 as income in 1954 and shown a liability at December 31, 1954 of $2,008,450.48. These two latter figures are shown in the next-to-the-last and the last columns of Exhibit No. 5.

Q. Mr. Cooper, I direct your attention to Paragraph 14 of the agreed stipulation of facts, which shows that out of all dues recorded on Plaintiff's books as having been received during the calendar year 1954, the sum of $2,039,264.74 is not accounted for as income or revenue in the calendar year 1954. How does that figure compare with the sum which would have been recognized as income had income been recognized in proportion to total expenses incurred on a monthly basis?

A. If income had been recorded in proportion to expenses, as shown on Exhibit No. 5, we would have reflected an income in 1954 out of the total of $4,078,529.17, we would have shown as income $2,070,078.69, which is approximately $30,000 greater than the $2,039,264.74 mentioned in the stipulation.

Mr. Bomar: Your Honor, I would like now to offer in evidence as Plaintiff's Exhibits Nos. 4 and 5 the two schedules which Mr. Cooper has described.

Mr. Kane: Your Honor, may I have the same objection [fol. 46] and exception?

Commissioner Bennett: You may. Plaintiff's Exhibits Nos. 4 and 5 are received.

(One-page document entitled "Monthly Costs and Expenses Five Years 1949 to 1953 (Divisions Only)," was marked Plaintiff's Exhibit No. 4 and received in evidence.)

(Document headed "Deferred Revenue—Membership Dues at December 31, 1954, Based on Cost Percentages for Five Years 1949 to 1953," was marked Plaintiff's Exhibit No. 5 and received in evidence.)

By Mr. Bomar:

Q. Mr. Cooper, have you prepared, at my request, from books and records of the Association, maintained in the normal course of trade and business, a schedule which shows the total number of members of the American Automobile Association Divisions during the calendar year 1953?

A. I have.

Q. And does this schedule also show the total monthly cost of serving all members of the divisions in 1953?

A. It does.

Q. And have you computed the average cost of serving one member per month during the calendar year 1953?

A. We have computed such average costs.

Q. Is this the schedule?

A. This is the schedule we prepared.

[fol. 47] Q. Would you please explain this schedule to the Court?

A. Yes, sir. This schedule relates to the year 1953 and it shows in the left column by month the number of members on our records that were to be served in each of the months during 1953. Thus for January we had 220,435 members. In December we had 246,856 members.

The next column is the costs incurred by all of our divisions in serving these members. It is the same cost figures that are shown in some of the previous exhibits we have introduced.

By dividing the cost figures shown by month by the members to be served in each month we arrived at the average cost of serving a member in each month of the year 1953.

You will note that this figure is 1.12 for January and 1.10 for December. It varies slightly during the year.

In the next column we have related these monthly costs per member to the total cost per year, and we have divided the 1.12 average cost per member for January by the total average cost for the year 1953 into $14.50 and have resulted in a percentage of 7.71 per cent for January, 7.57 per cent for February, and so on.

Q. Now, Mr. Cooper, if we advance or prepaid dues re- [fol. 48] ceived by the American Automobile Association from members of its divisions in the calendar year 1953 had been recognized as income or revenue in proportion to the average cost of serving a member per month, what proportion of the advance dues received in 1953 would be recognized as income and what proportion would remain in the liability account as of the end of the calendar year 1953?

A. The next-to-the-last column of this exhibit shows the actual dues received of $3,531,178.67. Applying the various percentages determined by month to the monthly dues received, we have arrived at a liability as of December 31, 1953 based upon the average cost per month of serving members, of $1,774,100.96. Therefore, the amount of income that will be reported out of the total of prepaid membership dues of $3,531,178.67 would have been $1,757,977.71.

Q. Mr. Cooper, I call your attention to Paragraph 10 of the stipulation of facts, in which it is agreed that as of December 31, 1953 the portion of advance dues which were not recognized as income in 1953 and which remained in the liability account, equaled $1,755,407.46. How does this compare with the liability account as of December 31, 1953 had advance dues been recognized as revenue in proportion to the average cost of serving a member per month?

A. This is shown in the last column to the right on Exhibit No. 6, and the liability computed on the basis of the [fol. 49] average cost of serving members per month is $1,774,100.96, which is approximately $19,000 greater than

the liabilities shown. I am not sure about that amount. The figure you gave was $1,755,407.46, I believe.

Q. The figure shown in the stipulation as representing the liability for unearned or deferred dues as of December 31, 1953 is $1,755,407.46.

A. That compares with our figure computed on the average cost basis of $1,774,100.96.

Q. In other words, had prepaid or advance dues been recognized as income in proportion to the average cost of serving a member per month, that liability as of the end of December 1953 would have been greater?

A. It would have been greater by approximately $19,000.

Mr. Bomar: Your Honor, I offer this schedule in evidence as Plaintiff's Exhibit No. 6.

Mr. Kane: Your Honor, I take the same objection and exception as before.

Commissioner Bennett: Plaintiff's Exhibit No. 6 is received.

(One-page document entitled "Year 1953 Deferred Revenue—Membership Dues Based on Average Monthly Costs Per Member," was marked Plaintiff's Exhibit No. 6 and received in evidence.)

[fol. 50] By Mr. Bomar:

Q. Mr. Cooper, have you, at my request, prepared a schedule identical to the one you just described except it relates to the calendar year 1954 instead of 1953?

A. I have.

Q. And was this schedule prepared by you or under your supervision?

A. It was.

Q. And was it prepared from records of the Association available in this courtroom which were kept in the ordinary course of trade or business?

A. It was prepared from our regular monthly statements and ledger.

Q. Is this the schedule?

A. Yes, sir, this is the schedule.

Q. And would you explain briefly the contents of the schedule?

A. The schedule is similar to the previous schedule which was labeled Exhibit No. 6, except this schedule relates to the year 1954.

Q. All right.

A. Again, the first column shows the number of members on the records of our divisions which were to be served for each month for the year 1954. The second column shows the total costs incurred by all of our divisions in [fol. 51] serving all of its members. The third column represents the average cost of serving a member, which was derived by dividing the actual cost shown in column 2 by the number of members shown in column 1. Thus we arrive at a figure of $1.27 for February, which compares with a total of $14.72 for the entire year.

Then we have related these average costs per member to the total average cost per member per year and arrived at a percentage which shows, for example, that 7.62 percent of the total average cost for the year 1954 were incurred in January, 8.62 were incurred in February, and so on.

Applying these percentages and the monthly dues received in 1954 which are shown in the next-to-the-last column, and totals $4,078,529.17, to monthly dues received, we have arrived at our estimated liability as of December 31, 1954 based upon the average cost of serving a member. This is shown in the last column and totals $11,078 for January and $33,919 of the February receipts, and so on, with a total liability at December 31, 1954 of $2,088,784 out of a total received in 1954 of $4,078,529.17.

Q. Under the schedule which you have prepared what proportion of advance dues received in the calendar year 1954 would have been recognized as income in the calendar year 1954 if recognition was based on the average cost [fol. 52] per member per month basis?

A. On the average cost per member per month basis we had actually received dues in 1954 of $4,078,529.17, which is the amount shown in the stipulation of facts in this case. We would have computed a liability based on the average cost of serving members for each month of $2,088,784. This amount subtracted from the total $4,078,529.17 would have resulted in income for the year 1954 of $1,989,745.17.

Q. I call your attention, Mr. Cooper, to Paragraph 14 of the agreed stipulation of facts in which it is agreed that out of the total advance dues received in the calendar year 1954, the sum of $2,039,264.74 was recognized as gross income. How does that amount compare with the amount shown in your schedule?

A. The $2,039,264.74 shown in the stipulation is greater than the amount of dues we would have reported on this basis, namely, $1,989,745.

Mr. Bomar: Thank you, Mr. Cooper.

I would like to offer this schedule in evidence as Plaintiff's Exhibit No. 7.

Mr. Kane: I would like to have the same objection and same exception, Your Honor.

Commissioner Bennett: Same ruling. Plaintiff's Exhibit No. 7 is received.

[fol. 53] (One-page document entitled "Year 1954, Deferred Revenue—Membership Dues, Based on Average Monthly Costs Per Member," was marked Plaintiff's Exhibit No. 7 and received in evidence.)

Commissioner Bennett: You may inquire.

Cross examination.

By Mr. Kane:

Q. Do you have before you Plaintiff's Exhibit No. 2?

A. Yes, sir.

Q. This is entitled "American Automobile Association Monthly Costs and Expenses." Will you describe for me what you included in those costs and expenses?

A. The costs and expenses include all of the expenses of all ten divisions for the years in question.

Q. That would include salaries?

A. That would include salaries, includes rent, includes stationery and supplies, includes commissions, the emergency road charges and so on.

Q. These commissions that you have just mentioned, they are commissions paid to the salesmen?

A. Yes, sir.

Q. And when do the salesmen receive these commissions?

A. He receives his commissions at the time a payment is made on the dues.

Q. A payment, a $5 payment?

[fol. 54] A. In proportion to the payment. It varies in the different divisions but generally speaking the payment is made to the salesman at the time the money is received from the member.

Q. He does not receive the $2.50 immediately?

A. No, sir, unless it is all paid at once, of course.

Q. In your emergency road service you take as a deduction or set up as a cost in each month the amount that is accrued during that month or the amount that is paid?

A. Our costs are emergency road service costs during the year and represent the month it was paid or incurred during that year.

Q. Or incurred. On your publication costs, how would that be handled if you incurred a $30,000 expense for publication of maps or anything of that type? When would that be taken as a deduction?

A. The cost of our touring publications are recorded as an expense at the time the Division actually receives the various materials.

Q. From the printer?

A. From the printer.

Q. It is not pro rated?

A. No, sir.

Q. Are you familiar with the method in which the accounts are kept, the bank accounts?

[fol. 55] A. Yes, sir, I am.

Q. What type of bank accounts do you keep?

A. A number of various checking accounts at various locations in which the receipts of our Division offices are deposited and from which the various expenses are paid.

Q. When you say "receipts" that is both membership dues, the amounts paid for publications by anyone, or do you sell them that?

A. There is very little of that. I am not sure of the publications. Do you mean tour books, directories and maps and so on furnished to our members as part of their service?

Q. Yes.

A. Very little, if any, are sold because the rules of the Association say these should be restricted to the membership.

Q. What other receipts do you have except dues and the return of some of the premium which I understand might happen throughout the year?

A. In our division that is substantially all the income. There is some income from all areas in all divisions for this, but some divisions have a driver training school, and there would be some small income from that. There is also payment received from our insurance agency by some divisions covering a portion of their expenses.

[fol. 56] Q. You have travel commissions. What would they be?

A. The travel commissions almost entirely are the commissions earned by our foreign travel department and are not a substantial portion, or they are a very, very small portion of our division income.

Some of our offices are qualified as travel agents in order to sell airline tickets, for example, so there might be some small income resulting from the sale of airline tickets by some of the offices, or there might be some small income resulting from the sale of tours by some of the offices, but the amounts in question involved would be very small.

Q. You file, as I recall it, a consolidated return for your ten divisions and national headquarters?

A. It is a return for the entire Association, which is one corporation. I wouldn't call it a consolidated return.

Q. I am not an accountant, but I mean a group return for the ten divisions.

A. All of the expense and all income for all of our departments and of our divisions are shown in one return.

Q. You said that your divisions would not handle the sale of publications, but does not your national office handle the sale of publications?

A. The national office sells publications to our affiliated [fol. 57] clubs, which are over 250 in number, and also makes these publications available for our own divisions.

Q. And your advertising sales, what do they consist of?

A. The advertising sales are principally the sale of space

in our various national touring publications. For example, our tour books for various areas in the country are combination directories. We have quite a substantial amount resulting from the sale of space in those books.

Q. When are these various items taken as income, at the time it is billed or at the time it is received?

A. These various items are taken as income at the time they are billed.

Q. You have a magazine. How is that income handled, or is there any income from your magazine?

A. We have a magazine in the District of Columbia Division which is called "The American Motorist." Some of our other divisions have other publications which are furnished to them. The magazines in all cases, the publications in all cases are published for the use of the membership and there is no income from that source. It is part of the membership package.

Q. Do you bill your members for that separately or is that included in the membership fee?

A. The magazine furnished to the member is included [fol. 58] in the membership fee.

Q. You have various items of income either in your division or in your national headquarters. Are these items of income segregated or are they all placed in a general fund between the various banks?

A. Are you referring now to the funds that are collected?

Q. That's right.

A. The funds that are collected are placed in our bank in the name of the American Automobile Association.

Q. In a general bank account?

A. In a general bank account, yes, sir.

Q. Do you have any restrictions of how division funds can be paid out or used?

A. We have no restrictions on the payment of the funds that were deposited in our general bank accounts.

Q. Just to clarify the record, isn't it a fact that a dollar per member is set aside in some manner covering magazine subscription, or is that just for the Post Office?

A. No, sir, my understanding of the situation is that the Postal regulations require that the subscription price be

named in the publication, and that figure is mentioned in the publication itself and I believe it also is mentioned on the membership application, but we make no actual segregation of the payment.

[fol. 59] Mr. Kane: I don't believe I have any further questions at this time.

Redirect examination.

By Mr. Bomar:

Q. Mr. Cooper, you spoke of advertising revenue. Do the divisions have any substantial amount of advertising revenue as contrasted with the national headquarters of the American Automobile Association?

A. No, sir, the divisions have practically no advertising revenue in comparison with the total received by national headquarters.

Q. And I believe you have testified previously that a stated set of books and records is maintained for each division; is that correct?

A. That is correct, and a separate income and expense record is kept for each department at the national headquarters and for each division.

Q. And in so far as the schedules which you prepared showing the total cost, did they or did they not refer to the total cost only of the division as contrasted with the total costs of the entire American Automobile Association?

A. They referred only to the costs incurred by the divisions and do not include any of the costs charged in the interdepartmental operation.

[fol. 60] Mr. Bomar: That is all.

Recross examination.

By Mr. Kane:

Q. May I show you Plaintiff's Exhibits Nos. 2, 3, 4, 5, 6, and 7?

A. Yes, sir.

Q. I see that Exhibit No. 2 speaks of divisions only on the costs. Exhibit No. 3 does not tell us whether that covers

the divisions only or the national operation. As I recall it this total income figure in the first column is for the entire operation, speaking of $3,531,178.67.

A. Exhibit No. 3 and also Exhibit No. 5 would show the dues received relating only to the division dues.

Q. They relate only to the division?

A. It would have been clearer had we so stated at the top of the schedule, but they relate only to the divisions. Just as the costs shown in Exhibits Nos. 2 and 4 relate only to the division.

Mr. Bomar: The stipulation says it applies only to the divisions.

Mr. Kane: That's what confused me.

I have no further questions.

(Witness excused.)

Commissioner Bennett: This might be a good place to recess for lunch. We will stand in adjournment, then, until [fol. 61] 1:30.

(Whereupon, at 11:55 o'clock a.m., a recess was taken until 1:30 o'clock p.m.)

AFTERNOON SESSION

(1:30 o'clock p.m.)

Commissioner Bennett: Mr. Bomar.

Mr. Bomar: Professor Paton, please.

Whereupon—WILLIAM A. PATON, a witness produced on behalf of the Plaintiff, being first duly sworn by said Commissioner, was examined and testified as follows:

Direct examination.

By Mr. Bomar:

Q. Would you please state your name and address?

A. My name is William A. Paton. My address is 2203 Hill Street, Ann Arbor, Michigan.

Q. What is your occupation?

A. My major activity is college teaching.

Q. And what is your present position?

A. My present position is Edwin Francis Gay University Professor of Accounting, and also Professor of Economics at the University of Michigan.

Q. Professor, how long have you served on the faculty of the University of Michigan?

[fol. 62] A. With minor interruptions I have served there for 44 years.

Q. And when were you made a full professor?

A. In 1921.

Q. Please describe briefly your educational background.

A. My undergraduate college work was taken at Michigan State Normal College and the University of Michigan. I held three degrees from the University of Michigan, including the Ph.D. granted in 1917.

Q. What was the subject of your doctoral dissertation?

A. The type of my dissertation was accounting theory with special reference to the corporate form of enterprise.

Q. Professor Paton, are you a Certified Public Accountant?

A. Yes, I am. I hold a certificate granted by the State of Michigan.

Q. Are you the author of any books; texts or treatises on the subject of accounting?

A. Yes, I am an author or co-author of 15 or 20 books and treatises. Perhaps the most important and best known among the textbooks are "Essentials of Accounting" first published in 1938, "Asset Accounting" published in 1952, and "Corporation Accounts and Statements" published in 1955. I might also mention that I was editor and the major contributor also to two editions of the Accountants [fol. 63] Handbook.

Q. Are you at the present time serving in any capacity as a consultant for the United States Government?

A. Well, I have one small connection at the present time in that I am serving as a member of the Educator-Consultant Committee, it is called, of the General Accounting Office.

Q. And do you now or have you ever served as a member of any committee of the American Institute of Accountants?

A. Well, yes, I served between eleven and twelve years as a member of the Committee on Accounting Procedure of the American Institute of Accountants, now called the American Institute of Certified Public Accountants. That, I think, is my principal assignment in that Institute.

Q. Professor Paton, have you, at my request and at the request of other attorneys in cases where you have testified as an expert witness on the subject of accounting, prepared a written statement which describes your educational background, your teaching appointments, the books and articles which you have written, the professional societies of which you are a member, your professional and business experience and other activities which are relevant to your qualifications as an expert witness on the subject of accounting?

A. Yes, sir, I have.

Mr. Bomar: Your Honor, at this time I would like to [fol. 64] offer as Plaintiff's Exhibit No. 8 this statement of qualifications of Professor Paton, and I would like to have him recognized as an expert witness on the subject of accounting in this case.

Commissioner Bennett: Have you seen the memorandum, Mr. Kane?

Mr. Kane: No, but I am familiar with Professor Paton and I have no objection to this going in evidence, and I recognize Professor Paton as an expert in the accounting field.

Commissioner Bennett: The statement is received. The witness qualifies.

(Document containing data regarding training and experience of Prof. William A. Paton was marked Plaintiff's Exhibit No. 8 and received in evidence.)

By Mr. Bomar:

Q. Professor Paton, have you read the petition filed by the American Automobile Association in this case, Government's answer, the agreed stipulation of facts, and have you

heard the testimony given by witnesses who preceded you in this case?

A. Yes, sir, I have read the petition and the answer and the stipulation and have heard the testimony that has been given up to date by the preceding witnesses.

Q. Are you familiar with the method of accounting em- [fol. 65] ployed by the American Automobile Association during the years in issue in accounting for dues received in advance from members of its divisions?

A. Yes, speaking rather generally, I would say that I am familiar with the method that has been employed by the Association.

Q. And are you familiar with the change in Plaintiff's method of accounting which the Commissioner of Internal Revenue seeks to force upon Plaintiff?

A. Yes, sir.

Q. Professor Paton, if the American Automobile Association is incorporated as a non-stock membership organization and finances its operations by means of dues prepaid for twelve months in advance by members of its divisions, and in return for such prepaid dues the American Automobile Association is obligated by contract or otherwise to render specified services to its members over the ensuing 12-month period following receipt of such dues, would it be proper, in your opinion, under generally accepted accounting practices for the American Automobile Association to treat as revenue or income in the year of receipt the entire amount of such dues even though the Club is obligated to render services to its members for a period which extends beyond the close of the taxable year?

Mr. Kane: Your Honor, before answering that question, [fol. 66] I want to interpose an objection to Professor Paton's testimony as an expert in this case, on the basis that I consider this testimony to be given in the form of an advisory opinion to the Court and that the issue before this Court is a legal issue rather than an accounting issue, and that any answer that he will give here today will be an advisory opinion, which we take the position is not proper matter for expert testimony, no more than having a lawyer testify as to what the law should be.

Mr. Bomar: Your Honor, in determining whether expert testimony is admissible, my understanding of the law is that first we must determine whether the matter under inquiry is subject to opinion testimony from the point of view of whether the issue involves an area where expert testimony would be helpful.

In my opening statement I called attention to the fact that the taxpayer is required to compute net income in accordance with the method of accounting used in keeping its books and records unless such method does not clearly reflect income.

I also call your attention to the fact that the statute, both section 42 of the 1939 Code, and section 451 of the 1954 Code, requires that all items of gross income shall be included in the gross income for the taxable year when received by the taxpayer unless the methods of accounting [fol. 67] permitted such amounts to be properly accounted for as of a different period.

It seems to me that no matter what the witnesses who I propose to qualify as experts testify in this case, it would have no bearing on the ultimate legal question to be resolved, whether tax law differs materially from generally accepted accounting principles.

Furthermore, there are numerous cases in which experts have been permitted to testify on the ultimate issue involved in the case, such as reasonableness of salaries. Experts are qualified from that view when that is the sole issue in the case, such as valuation of property and that is the sole issue in this case.

I think that the issue involved in this case clearly is one in which expert members of the accounting profession are peculiarly qualified to render competent testimony.

Commissioner Bennett: The objection is overruled.

Mr. Kane: May I have an exception, and the same throughout the testimony of experts, an objection and exception?

Commissioner Bennett: You may.

Mr. Kane: Thank you, Your Honor.

The Witness: No. It would not be proper.

By Mr. Bomar:

Q. And why not?

[fol. 68] A. It would not be proper because the procedure that you described is in conflict with an absolutely basic principle of accounting, namely, that we must distinguish between a financing transaction and revenue or income transactions. I regard that as pretty close to the cornerstone of accounting.

Q. What do you mean by a financing transaction?

A. Briefly a financing transaction is a transaction in which funds are raised by any organization or enterprise to get it going and carry on its activities. There are three main ways of doing it. Speaking of corporations and organizations generally, substantial funds are raised from stockholders. Another source, a second major source is borrowing at the banks or from other lenders. Third and actually quite an important source is that of advances by members or customers.

Many companies would utilize primarily the first two sources, acquiring funds from stockholders or from creditors such as banks and other lenders, especially in a membership, a non-stock organization, and I understand that the American Automobile Association is of that nature, it is not only commonplace but appropriate, one might also say, naturally to rely on the members for advances to get the funds necessary to carry on operations.

Q. What do you mean by a revenue or income trans-

[fol. 69] action?

A. A revenue or income transaction occurs when some organization, corporate or otherwise, furnishes a product or renders services and no revenue can emerge in the very nature of the case until product is furnished or services are provided. That I regard as an undisputable principle of accounting and it is universally recognized, as far as I know, in the accounting field.

Q. Professor, would you give us an example which would distinguish between a financial transaction or a revenue or income transaction?

A. Well, there are, of course, many examples in business

operation. I might be permitted perhaps to try my hand at a very simple hypothetical example in an effort to bring out what I regard as the underlying point involved.

Suppose, Mr. Bomar, that at about the end of a taxable year you deposited $100 with your tailor in connection with an order, which he has agreed to, to make you a nice overcoat at a cost of $300. Now, assuming that we are approximately at the end of his fiscal and taxable year—I don't know that it is even necessary to throw that assumption in—but at any rate when that transaction occurs you are depositing $100 with your tailor in connection with this order for an overcoat.

Proper accounting for a tailor would require the estab- [fol. 70] lishment of a liability account in your name for the amount of that $100 which you deposited with him as a means, perhaps, of helping to finance his purchases of materials and other costs to be incurred in the making of this coat. He is just in the same position substantially as if he had gone to the bank and borrowed $100 or you had signed his note at a bank for $100.

Now, if that is the situation still at the end of his taxable year, it is absolutely essential that he show a liability to you of $100 in his financial statement and it would be absolutely incorrect for him to treat that $100 as an income item.

Now, in the following year when he makes up the coat, buys the material and makes up the coat, he now has a revenue transaction, and the proper accounting for that would be to recognize a revenue or sale, as we often say, of $300 and a charge to you as a customer of precisely that same amount.

Now, we have arrived at the final stage of settling these two claims, your claim against him for the advance of $100 and his claim against you for providing you with a product, this coat, at an agreed price of $300.

Now, two methods of settlement are open to you: You mght pay the tailor $300 and then he might pay you $100, returning the amount of your advance, which, if he had [fol. 71] borrowed from the bank, that is what he would do. Or instead of that he may deduct the $100 claim in your favor from the $300 claim in his favor and bill you

for $200. That's precisely the way that invoice would be typically set out, but that does not alter the fact that in the first year we have a financing transaction in which you provide the tailor with $100 in just as clear-cut way as if he had gone to the bank to get it, and that remains a liability, I assume, at the end of the year, and the second year revenue emerges and the settlement of these claims also develops.

Q. Professor Paton, can you or not apply the principle of accounting you have discussed and illustrate it to the facts in this case?

A. Yes, I think I can as I understand the facts.

It seems to me that my little example is absolutely on all fours with the facts in this case, that when a member makes a deposit of any amount of money in advance of the rendering of service by the association, or one of the constituent branches has agreed that we have no revenue transaction, there is no such thing at that stage as revenue or income. Instead we have a bit of financing and I don't regard it of any consequence whatsoever that the amount advanced might be quantitatively or equivalent to a year's dues. I think it is at that point some people get confused about such cases.

[fol. 72] The plain fact is that at that point the Association has incurred a liability, the Association has received funds from members in lieu of other methods of financing. Now, as through the passage of time the Association renders services as agreed, the revenue transaction emerges, and under prevailing practice an arrangement is worked out under which the liability is discharged instead of a payment by providing service as agreed. That doesn't alter one iota the fact that one transaction is raising funds and the other transaction is the revenue transaction.

Q. Professor Paton, does sound accounting practice demand that there be a distinction between the receipt of advance dues which you described as a financing transaction and the rendering of services which you describe as an income or revenue transaction?

A. Yes, it certainly does. First, I perhaps have already said I consider it a basic principle of accounting practice

to draw that distinction, and I think it is universally acknowledged among accountants. I don't know of any reputable accountant that would hold anything to the contrary, and I think that is true for a long period of years.

Q. Professor Paton, the pleadings in this case make it clear that the American Automobile Association uses the [fol. 73] accrual method of accounting. Under the accrual method of accounting, is it essential that income be recognized only as services are rendered or made available?

A. Yes, it is, but I would like your indulgence to clear up something there.

In my opinion it doesn't make any difference whether the taxpayer is on the so-called accrual basis or on the so-called cash basis, as I understand the situation. Whichever basis he is on it is absolutely improper, it is unsound accounting for a taxpayer to treat money secured at the bank as if it were revenue or money secured, with which to operate, from members, as if it were revenue.

My understanding of the cash basis of accounting—and I am subject to correction, because I think I know something about this—but we do have a system under which the taxpayers—we refer to the taxpayer in that category here—is permitted under some types of circumstances to defer the recognition of revenue that has already been earned and produced until cash is received.

I report my return on the cash basis. I report the cash paid to me each year as my cash income.

Q. Professor Paton, if receipts in the form of advances by members or customers are treated as taxable income entirely in the year of receipt, is there a possibility that taxable income over a period of years will be overstated [fol. 74] and that the total tax collected from the particular taxpayer will exceed the statutory rate applicable and may even include a levy on capital funds in the guise of an income tax?

A. Yes, there is very clearly such a possibility. I might take perhaps a rather extreme example that is not literally identical to the case we are considering, but it seems to me it is the same principle. Let's suppose a new company was organized to make machine tools or some other products and the funds to build the buildings, let's say, were

secured from the stockholders and funds to buy materials were secured from some interested customer who has ordered quite a number of these units of product that the company is going to make. Now, if a part of the money advanced by that customer who is making these orders were seized as income taxes, not only would we be taking money obviously raised to acquire these inventories but we would be taking money before we know whether the company is going to be able to operate at a profit.

You would seize funds that are being used to finance a business prior to the production of revenue and the assembling of the costs, and you may very well have a tax levy when there is literally no income at any point.

If, for instance, the price that was agreed upon for this customer I am thinking of weren't high enough to develop [fol. 75] some of the cost that might unexpectedly appear, it might be that the company would operate at a loss. It seems to me that in such a situation it would be ridiculous to take some of that money and call it income.

Q. When in your illustration would the income for revenue purposes take place?

A. When the goods are provided for the customer as agreed by the contract.

Q. Professor Paton, when you refer to an income or a revenue transaction are you referring in general to items which appear in a profit and loss statement, or are you not?

A. Yes, in a profit and loss or income statement. I prefer the term "income statement," but it doesn't matter and I am using them both because sometimes we find the term "revenue" and the "total sales price" and sometimes we apply the net income to a net or intermediate figure, but the elements I am thinking of are income statement elements, yes, sir.

Q. Professor Paton, can the error which you described in accounting in the case of the machine tool manufacturer happen to such an association as the American Automobile Association?

A. Well, it seems to me it clearly can. I don't know the details of the Association, but it seems to me they clearly can.

[fol. 76] If I might try to focus on something to bring out the point, let's suppose, for instance, that the Association toward the end of a taxable year staged quite a membership campaign and got quite a bit of money in toward the end of that year covering membership so that can operate as of the first of the following year. It might well happen that unexpected developments may create an element of cost when the Association undertakes to furnish the services or provide the services for the membership as agreed, a level of cost might emerge that would wipe out any possible income margin with respect to this batch of customers during the year in which revenue were being produced and costs being incurred. In fact, I would be surprised if that sort of thing wouldn't happen from time to time wherever funds are levied upon in the gross prior to the incurring of costs or the creation of the revenue itself.

Q. Professor Paton, you will note from the agreed facts in this case that the American Automobile Association recognizes advance dues as revenue or income as services are made available over a period of time of the membership. Will you please state whether or not there is any justification for recognizing as income or revenue advance dues on a time basis?

A. Well, it seems to me there is considerable justification. The contract itself is on a time basis. I feel espe-
[fol. 77] cially for tax purposes the important thing is that the year's recording be handled in such a way that for the year the transactions with members are treated soundly, as I have tried to suggest. The time basis does not offend me at all. I would doubt if there is any other basis that is more realistic, especially when you consider the practical side of it and the way the thing is regarded by both the Association and the member.

I might say I am probably one of the oldest members of the Michigan Automobile Association and it is my understanding when I deposit my dues that over a stated period of time the thing that I am acquiring is the right to receive a series of services of one sort or another specified in the arrangement, and hence proration over a time, as time

passes, strikes me as being perfectly realistic and reasonable.

Q. Professor Paton, Mr. Arthur I. Cooper has testified that even had advance dues been pro rated as costs were incurred on an average cost per member per month basis, that the recognition of revenue during a particular year and the amount of the liability as of the end of the year would not have been materially different than if revenue is recognized out of the advance deposits on a time basis. Would that testimony fortify your conclusion that time is a proper yardstick for measuring the obligation that the [fol. 78] American Automobile Association is performing or the expiration of its liability to render services?

A. Yes, I think it would to some extent. That is, I would be inclined to recommend that such study be made from time to time just as a means of seeing whether the relationship can be properly recorded on a time basis.

My feeling still is that time basis is thoroughly sound and that cost data of the kind presented that I was listening to this morning, are primarily important for the purpose of testing the general reasonableness of the time basis and seeing whether there is anything uncapricious or outlandish about such basis.

Q. The feeling has been expressed by others that such a method of accounting would be artificial if advance dues were recognized on a time basis unless it was proved that the relationship between the income and services be rendered. Do you agree with that view from the accounting point of view?

A. No, I don't agree with that point of view or any other point of view as far as understanding the operations of an automobile club or an association, though such understanding as I have, if anybody can find a better basis I would like to see them do it.

The Club, the Association, by contract agrees to provide a package of services and conditions. Now, fluctuations [fol. 79] between months, if there were such, wouldn't frighten me particularly, because I would be looking back as a whole, and I think time is a very good and realistic basis for saying that the Club has undertaken to provide a package of services over a period of time, but I don't

object, on the other hand, to studies which I think should be made from time to time to test things out and see how other aspects of the situation fortify or raise questions about the time basis. I wouldn't want to insist here the time basis is the only basis with which one might spread the revenues of a service organization.

Q. Professor Paton, if you were employed by the American Automobile Association as an independent expert to advise them how to set up their books and records in order to reflect and recognize advance dues on a proper basis, what method would you recommend?

A. Well, I might quibble a little bit about the account titles, maybe prefer something a bit different, but I would emphatically recommend that the Association's usual method of accounting which sets up at the end of each year on a reasonable basis the outstanding obligations to members as a liability and to recognize revenue as services are rendered or made available through the year. In fact, I can't see any justification for anything else. Now, I understand that is what the Association has been doing for [fol. 80] many years, and if my understanding is correct I wouldn't have any quarrel with them on any essential points whatsoever.

Q. Professor Paton, is the method of accounting for advance dues which the Commissioner of Internal Revenue seeks to impose upon the American Automobile Association in accord with generally accepted accounting principles?

A. No, sir, it is not. It is absolutely 100 per cent in conflict and always has been where it has been tried, and I might add it is entirely indefensible. It should not even be considered debatable, and I was disturbed for many years handling this correctly, in income tax and other connections we started trying to do the wrong thing.

Q. Professor Paton, I call your attention to page 282 of the book to which you have referred, "Corporation Accounts and Statements," wherein you write:

> "The term 'deferred revenue' is sometimes applied to balances representing amounts collected from customers or clients in advance of the delivery of goods

> or the furnishing of service. As emphasized later, such balances are liabilities, not revenue credits deferred or otherwise."

Does the statement which I have quoted apply to the account entitled "Deferred Revenue—Membership Dues" referred to in Paragraph 7 of Plaintiff's Petition?

A. Oh, yes, clearly that is an example of the very kind [fol. 81] of situation I have in mind there, but those balances are clear-cut liability balances and I personally prefer to describe them as advances by customers or something of that kind rather than just a particular type.

Q. I also ask you to turn to page 416 of the same book, of which you and your son are the authors, and in which you write:

> "A type of liability frequently misinterpreted is represented by 'unearned' or 'deferred' revenues so-called . . . the proper general caption for such item is 'Advances by Customers' and that should be reported in clear-cut fashion under liabilities."

You continue on page 417:

> "In a number of cases the Internal Revenue Service has taken the almost incredible position that advances by customers constitute revenue for tax purposes in the period received, even if the taxpayer's accounting is on a strict accrual basis and even if no goods or services have been delivered in such period."

Is this still your view?

A. It most certainly is and it always has been, I might say, as we considered this a very elementary point in accounting, and I have never heard of anything ever being preached in a classroom or anywhere else.

[fol. 82] Commissioner Bennett: You have taught it that way for 44 years?

The Witness: Yes.

Commissioner Bennett: And when was your book published from which the quotation has been made?

The Witness: This particular book, Your Honor, was published in 1955, but you will find the same material I have written with the exception that in most of them you won't find this book at the Internal Revenue Service.

By Mr. Bomar:

Q. Professor Paton, we have been talking about the income account of the Association primarily. I want now to direct your attention to the balance sheet as contrasted with the income account. The balance sheet of the American Automobile Association is evidence in this case established here and always as a liability account, which is referred to as "Deferred Revenue Membership Dues." Does sound accounting practice require this amount to be shown as a liability on the balance sheet of the American Automobile Association?

A. In my judgment it most certainly does. It is a liability.

Q. Professor Paton, would you as a certified public accountant certify to the accuracy of the income statement or the balance sheet of the American Automobile Association if the Commissioner succeeds in changing its method of accounting?

[fol. 83] A. No, I certainly would not even consider it for a moment. The thing is unsupportable and I wouldn't know offhand of any professional accountant who would say differently.

Mr. Bomar: Thank you, Professor Paton.

Mr. Kane: May we have a short recess, Mr. Commissioner?

Commissioner Bennett: We will take a ten-minute recess.

(Short recess taken.)

Commissioner Bennett: Proceed.

Cross examination.

By Mr. Kane:

Q. Professor, you talked about the accrual method of accounting and deferred revenue or deferred receipts method. In normal accrual accounting, as I understand it,

you take into account the amount when it is billed to a customer whether or not at that point you have rendered the service to that client; isn't that right?

A. No, sir.

Q. It is not right?

A. No, sir.

Q. In other words, if I go to a store and purchase a suit in late December which is not furnished to me until some time in January, the store bills me the 30th of the month, the 30th of December, they do not accrue that as income in December?

[fol. 84] A. I couldn't guarantee that there is no store that does not violate the principle, but that is something we are very touchy about in accounting. That would not be correct accrual accounting for revenue to be credited—you used the word there—in December with a sale in which the furnishing of the product doesn't occur until later.

Now, there is one possible exception to that, sir. If the circumstances were such that the coat was already in existence and was segregated as the property of the customer, it is the exception but I don't think we need refer to it in the retail situation, but there might be instances the fact that the product had not physically left the possession of the vendor would not be the decisive thing provided the product is there waiting delivery and all the conditions have been taken care of. For instance, a wholesaler might order a big shipment of cans from a canning factory for canning tomatoes, let's say, and if the customer had those tomatoes on hand and set them aside as the property of the customer, I would be willing to say that under some of those conditions you do have a revenue transaction and that the billing is validated by a revenue transaction. But, speaking generally about manufacturing and trading companies, I would say that the last thing in the world any of us would tolerate in accounting would be the inclusion in revenue in the current year of prospective sales even though normal billing or formal billing had [fol. 85] been instituted.

Q. If they billed me in December and the coat was delivered to me in December and I did not pay for it until

some time in February or didn't pay for it at all, when would it be accrued as income?

A. In that situation the revenue would be recognizable under proper accounting in the month of December regardless of the fact that the transaction might turn out to be a bad debt. In other words,—

Q. An adjustment would be taken in the following year as a bad debt?

A. The bad debt loss would occur later when the account went sour.

Q. Professor Paton, you called these dues, in effect, advances from the members. Now, you also said, I believe, that advances are usually thought of as subject to a service being performed or a refund being made if the service is not performed. I believe you used a hundred dollar example.

A. Yes, I didn't say specifically anything about refund.

Q. But I am asking you about refund.

A. Okay.

Q. I think it follows in the same order. Do you know if the dues in this case are subject to refund?

A. I don't know for certain about that, sir:

[fol. 86] Q. May I ask you do you know as a member of the Michigan Automobile Club, which you say you have belonged to for many years, whether there are or have been years in which you required no service?

A. There have been years in which I did not require them to pull me out of the ditch or anything of that kind, but I do not consider that is what I am paying for. I am buying the availability of the service, I am buying the protection and that is what I am paying them for when I take out membership. I hope they will not have to pull me out of the ditch, in fact.

Q. The same as insurance?

A. I consider it a very close relationship between an insurance situation and this type of situation with regard to the type of product.

Q. But it is conceivable they have a few cases, a few members or many members who ask for nothing as an item of direct expense to the organization during the fol-

lowing year. I am not talking about overall management salaries but pulling a man out of a ditch, asking for travel folders. Is it possible there would be many members that would ask for no service of that type during a year?

A. Oh, yes, I think that is clearly involved. You are dealing with a group or pool. Any pooling or risk situation, particular members may in a particular year require [fol. 87] very little of a specific service that is rendered to certain other members. I wouldn't know what the experience on that would be, but I would think it would be rather irregular between individual members.

Q. But your fixed liability as you see it in contrast to the overcoat transaction is their being liable to render these services?

A. Well, I have always understood that is what I am buying and that is the regular understanding that I am buying the availability of services, the protection and paying for it reasonably, and I hope I won't have any bad luck.

The specific intentions, they are agreeing to furnish certain services—there is a considerable difference, I might add, on varying types of business of that kind. Frankly, the irregularity of the actual furnishing of the maps and helping you out when you run out of gasoline and so on, I frankly don't think that has a blessed thing to do with the over-all accounting.

Q. Now, this view of others that you mentioned you took issue with, would you mind clarifying for the record whose views they are?

A. I was asked, I believe, a question to this effect, that there are others who regard the recording or recognizing of service on a time basis as artificial. There was nothing mentioned as to who these others are in question, but my [fol. 88] answers simply were if there are folks of that stripe I don't agree with them.

Q. It might be the Supreme Court?

A. Are you asking me, sir?

Q. Yes. You heard the testimony this morning and the opening statement?

A. Yes. I am not familiar with the details of the Michigan case, but I am quite sure I saw reference to it in the papers originally and I heard what was said here today

and have some little familiarity with it, and I don't know what facts were presented to the Court, but on this particular point we have under consideration here now the Court reached absolutely the wrong decision.

Mr. Kane: That is the reason for my objection to this type of testimony, Your Honor, it is an advisory opinion.

By Mr. Kane:

Q. Now, there were some charts shown here about expenses. You said that you believe that the proper method was to pro rate on a time basis the dues, that expenses as I recall it would be for testing purposes from time to time to see how your system was working out. Is that a fair statement?

A. Yes, that is my recollection. I just add this word, that I consider the basic question I have been addressing myself to, this question of making sure we have a liability [fol. 89] appropriately calculated set up at the end of each accounting period and that the revenue transaction and the services rendered be recorded over a period of time in a reasonable way.

Now, I don't hold any rigid plea for a strict time basis. It looks to me as though it is the most realistic and practical and sensible and strict situation.

Q. You would say, then, that it wouldn't be proper to prorate expenses over the same year?

A. No, I wouldn't say that.

Q. You would not say that it was not proper to prorate expenses?

A. No.

If I might elucidate very briefly on that. The accounting that is on an income statement, I regard in this way: The measure of the revenue up at the top of the statement I think is a relatively simple thing. The determination of the costs that are perfectly applicable to that revenue is a much more controversial subject. I don't think we in accounting do as good a job in that area in general as we do in the area of simply setting up the revenue figure at the top of the income statement, but I am a thorough-going

believer in our perfecting our charges for deductions in so far as it is feasible and practical to do so, so that we have a reasonable relationship between the charges and the [fol. 90] revenues.

Q. I believe you testified that in effect this method that the Commissioner advocates would at times result in his taxing as income either capital or loans not actually earned; is that correct, sir?

A. It seems to me it is quite likely to result. You are levying a tax upon receipts that in the first instance are funds advanced to finance activities, so you are levying a tax to start with on a gross figure. It seems to me quite possible, quite likely in fact, that from time to time the levying of a tax prior to the creation of a revenue and the expense accounting will result in seizure as income taxes of funds that are not income in any sense of the word.

Q. Now, that is from time to time, in other words, not just at the beginning of the business but from time to time to put some changes in the number of memberships that will occur?

A. Yes, unexpected changes in expenses, loss periods and so on. Now, I haven't worked out any examples to my satisfaction in detail in that area, but that's my impression, and, of course, we can see at the beginning of a business, we can see the thing more clearly, but what I do from time to time say, that that situation would arise after the operating history, after you got rolling presumably from time to time. But I don't think we can hope that there [fol. 91] will be a coincidence from year to year between the advances by customers and any organization that utilizes that method of finance and the volume of service and product produced in that year. That would be a sheer coincidence if they are identical. That creates the possibility of levying taxes on funds that not only are not income to start with but will never be in any sense of the word an element of net income.

Q. Now, continuing that, as long as you have a curve upward of members and you are prorating part of the income into the next year for the revenue, gross receipts, wouldn't it follow that if the expenses were increasing to serve more members that you would be putting in part of

the expenses in the latter months of the year, you would be increasing the expenses so that your net income would always be less as long as you have an upward curve of members?

A. I am not sure I follow you. I don't see anything about an automobile association, or, for that matter, any other business which deserved the general conclusion that there will be a trend upward of revenues or a trend upward or downward of expenses. That would depend on a lot of circumstances, but, to my mind, sir, there is a fatal effect in taking money as income before income emerges, in that you have deprived the taxpayer of funds too early, and in the second place you run the risk, but even year by year there will be substantial injustice done. That's a question [fol. 92] I think you would have to postulate a lot of facts rather carefully how it would work out.

I am not trying to evade your question, but I don't know the answer.

Q. My question is premised on exhibits put in by the Plaintiff, and I note that each year's expenses have gone up anywhere from three or four hundred thousand dollars to over a half million dollars in an exhibit right here, and my question is premised on the fact that some of those expenses during those years may have been applicable to the new memberships, the income from which is being turned over into the next year under the Plaintiff's method of accounting.

A. Oh, I think that is quite possible, that some of the costs that are incurred and are recorded as expenses currently by the Association, that we could find fault possibly with some treatment there. I wouldn't think in the automobile association business that they would be as serious as we might find in manufacturing and some other cases, but I would recommend, as I understand the Association follows, the practice of spreading the commissions to salesmen, because they relate to a particular element received from the members.

Now, I wouldn't, on the basis of any information I have, want to be either critical or applaud the general treatment of this and that cost like office supplies and salaries of [fol. 93] stenographers and others. I don't know of any-

thing strikingly wrong about that area of accounting for the Association, but I can't testify to the advantage or disadvantages of the things they are doing.

I said a little while ago, and I would like to refer to that in the field of determining the cost assigned to the volume of sales or services rendered, we do have a lot of difficult accounting questions.

Q. Why would you say that the salesmen's commissions that you just referred to are more direct expense than publications, road service or any of those things, other expenses incurred for a member?

A. Well, I don't know that I know enough about the operations of the Association to speak very positively on that, but it does seem to me that the commissions specifically related to amounts advanced by customers, that there should be some justification for spreading through the year by months especially if you are going to spread services rendered by months through the years, and wherever anything of that kind is substantial, I think you include your accounting somewhat by appropriate spreading.

Now, when you come into the field of publication costs that is something like the question of advertising in business generally. I remember when I was in the Internal Revenue Service 40 years ago for a year, that we were [fol. 94] worrying about advertising cost, whether we should permit advertising cost as a deduction in the year in which the money was spent or the billing occurred, like some late advertising in the Saturday Evening Post, say, about this time of year, or whether we should try to insist on some method of deferral and, generally speaking, the method of deferral. You didn't try to do much with it because of the great difficulty in deciding when the results of some of these expenditures might be. Now, publication expense, I don't think I should pass judgment on that. I don't think I know enough about it, Mr. Kane.

Q. You gave as the only thing they now prorate is the salesmen's commissions.

A. Yes.

Q. In this case.

A. One other thing, I think it was mentioned the cost of accident insurance was prorated also.

Q. Yes, accident insurance. No, it is not prorated.

A. I understood it was and always had been.

Q. You heard some testimony this morning as to the change in 1954, which is the same thing we are talking about, and there was also mention of items on the books as of the end of the year, a small figure, roughly $44,000, which they treated as an accounts receivable in a memorandum form only, which was not placed on the books. Would [fol. 95] you say that proper accounting as described this morning would require them to include that or a portion of that $44,000 in their income for 1954 when they had been doing it each year up until then?

A. As I understand the change, and I may not be entirely clear on this, but as I understand the change it would not result in inconsistent accounting or any material change, because I would regard accounts receivable that had been set up at the time the application is received and no funds had yet come in as a sort of memo account and the corresponding credit in deferred revenue account or whatever you call it, I would call an offset and I would say the offset was a change in these two methods of accounting. That would seem to me preferable to what they would be doing previously and not inconsistent with it.

I am not undertaking to say that an accountant from absolutely every standard knows anything about it, but I don't see that that particular change is substantive to the matter I have been addressing myself to here.

Mr. Kane: I have no further questions.

Redirect examination.

By Mr. Bomar:

Q. Professor Paton, Mr. Kane asked you your opinion as to whether the American Automobile Association had a practice of making refunds to members, and as I recall your [fol. 96] testimony you stated that you didn't know. Would it make any difference under sound accounting practices from the viewpoint of distinguishing a financing transaction from a revenue transaction whether the Club does or whether the Club doesn't make refunds?

A. I don't think so. It is an incidental thing which would draw a little distinction advanced by a customer and a member and a bank loan, but if in incidental cases refunds were restricted or were not available it doesn't seem to me that alters the basic proposition that the money advanced by the customer is an advance and is not revenue.

Now, some subsequent development might involve some small adjustment, I don't know, but I think I can state that pretty clearly and flatly that I can't see that that fact settles the question at all of what is a revenue transaction there and what is a financing transaction. To me the advance by the member is the provision of some funds prior to the emergence of revenue.

Q. Professor Paton, under sound accounting practices is there any point in deferring expenses or in postponing the deduction for an expense unless it is a truly prepaid expense?

A. Well, that is a big question, Mr. Bomar. I think that the association of expenses with revenues is a difficult [fol. 97] question and involves many debatable points, because what we are really after is economic associates, and the word "prepaid" is a little bit restrictive to cover all such cases.

Q. Professor, is it debatable as to whether the advance dues should be deferred?

A. In my judgment it is not debatable and never has been.

Q. Professor, are you stating that even though no expenses are deferred, that you should still distinguish between advance dues and the recognition of dues as income?

A. There isn't any question in my mind but it is improper accounting to treat as a revenue, advances prior to the rendering of service, and that in itself—I amnot going to condone any bad accounting for expenses by saying that, but that's a distinct, basic consideration in getting started with your accounting at all.

Mr. Bomar: Thank you.

Recross examination.

By Mr. Kane:

Q. Didn't you say that the normal advance for loan as we think of it would indicate the right to a refund if the service was not rendered?

A. It depends on the way the contract is drawn, but I think of the person or entity receiving such advances from [fol. 98] customers and members as incurring an obligation and the proper utilization of those funds or the return of such funds, and I don't know enough about all the types of contracts we have in this area just to know when a refund is in order.

We know sometimes in the fire insurance business you are entitled by agreement and sometimes by request to a refund, so that generally speaking the producing entity does unquestionably incur the obligation. Now, what the basic law is I couldn't say.

Q. We are not asking you the law, Professor. Wouldn't you say that is true in subscription income, that normally if you cancel your subscription, like a newspaper subscription, that you are entitled to a refund?

A. I was under the impression that quite frequently you are not.

Q. On a long-term contract?

A. That I am not sure of. If you had a four or five-year subscription—my impression is that those contracts usually provide that you are not entitled to a refund, but what the practice is I couldn't be positive.

Mr. Kane: I have no further questions.

Commissioner Bennett: Thank you, Professor. You may be excused.

(Witness excused.)

[fol. 99] Mr. Bomar: Mr. Baker, please.

Whereupon—GEORGE E. BAKER, a witness produced on behalf of the Plaintiff, being first duly sworn by said Commissioner, was examined and testified as follows:

Direct examination.

By Mr. Bomar:

Q. Please state your name and address.

A. George E. Baker; Rosecroft Road, Manor Club, Rockville, Maryland.

Q. What is your occupation or profession?

A. I am a Certified Public Accountant and a resident partner in charge of the Washington Office of Ernst & Ernst.

Q. Would you please describe briefly your educational background, Mr. Baker?

A. Bachelor of Arts Degree from the University of Wisconsin, and a major in accounting.

Q. How long have you been a Certified Public Accountant?

A. Since January 1941 in Ohio, and at the present time in the District of Columbia and several other states.

Q. Please describe your experience as an accountant, how long and where you have served as an accountant.

[fol. 100] A. I started with Ernst & Ernst in 1936 in Cleveland, went to Dayton, Ohio as manager in 1950, to Washington as manager in 1953. I was made a resident partner in 1954.

Q. Mr. Baker, it has been testified that Ernst & Ernst were the independent public auditors of American Automobile Association during the years in issue in this litigation. Who in the firm of Ernst & Ernst was in charge of that audit?

A. As manager of the Washington office I was in charge, general over-all supervision.

Q. Mr. Baker, did you issue a statement in connection with the independent audit to the effect that during the years 1953 or 1954 the net income of the Association computed in accordance with the method of accounting described in Paragraph 7 of Plaintiff's petition was in accord with generally accepted accounting principles?

A. I did, yes, sir.

Q. Mr. Baker, if the Commissioner of Internal Revenue succeeds in forcing the Plaintiff to change its method of accounting so that it is required to report advance dues as income in the year of receipt, would you or your firm certify the accuracy of the profit and loss statement of the Association?

A. For the year 1954 that would mean a distortion in the balance sheet of about $1,600,000 reduction of liabilities [fol. 101] and increase in surplus, and that would be such a substantial distortion that we would either not issue a report or if we did, deny an opinion.

As to the profit and loss statement, it would mean a difference of $200,000 or $300,000 in income difference between prepaid subscriptions and the end of the year, and that, again, would be so substantial and so much in variance with generally accepted accounting opinions, that we would not render an opinion, would deny an opinion for it.

Mr. Bomar: That is all.

Cross examination.

By Mr. Kane:

Q. You would deny an opinion. Just exactly what does that mean?

A. We render what we call an opinion as to the statements as to the facts, that they present fairly the financial position of the corporation or association and the results of its operations in the year under review. We do not longer use the word "certify" when we deny an opinion, we state why the statement contains certain items on the statement with which we do not agree and we cannot give our statement that the statement fairly presents a true condition or the operation of its operation.

Q. If this case were decided adversely by the Courts, you just would not render an opinion?

[fol. 102] A. That's right.

Q. And this would go on until the law was changed or forever?

A. Well, the courts do not dictate to us as accountants

what we shall show, unless it is an accounting case. This is a tax case.

Q. But from an accounting standpoint if they add up to higher taxes, then, not being an accountant, it would seem in their statement it would be less income.

A. Yes, sir.

Q. And that would show what they actually had, would it not?

A. It would show a tax very large in proportion to their true income based on generally accepted accounting principles.

Q. Rather than an opinion you would just give some footnote as to why it was done this way, you did not agree with it but it had to be done this way?

A. You are talking about increase in tax only?

Q. The entire balance sheet or financial statement.

A. If we revert to this position the Commissioner is trying to impose upon us now, we would deny an opinion, as I said before.

Commissioner Bennett: You don't give an opinion unless you can prove it?

[fol. 103] The Witness: That is correct. They are company statements, sir. We cannot force the company to change their statements but we can render or deny an opinion.

Commissioner Bennett: You never say why you don't give an opinion, you just don't give it?

The Witness: No. We generally do say why we do not give an opinion.

By Mr. Kane:

Q. You have heard the testimony here this morning and are familiar with the accounting in both 1953 and 1954?

A. Yes, sir.

Q. Do you feel there is any difference between the accounting procedure employed between 1953 and 1954?

A. There were some differences in the methods of handling specific items. I would say they were not in any sense a change of accounting principles, they arose as a result primarily of a survey we have been making of the

accounting methods of the Association. There were differences in handling specific items. They were, we thought, improvements in handling specific items. We can't go along year after year doing everything exactly the same when there is actually a need for improvement.

Q. I think the Commissioner has heard enough of this item to take a minute to [redacted] an explanation for the record of this change in so f[redacted]any one instance which we [fol. 104] have discussed, but also how you changed in so far as income is concerned. The one-twenty-fourth and the 50 per cent. Will you explain that?

A. The membership income, income for memberships?

Q. Yes, sir.

A. Prior to 1954 the method used to spread that income over practically every case for a year was to credit it all to deferred income, a liability account, and then we took into income 1/24th of the amount the first month, 1/12th the amount the succeeding 11 months, and 1/24th of the amount again on the 13th month, which seems a reasonable way of spreading it over a year.

However, again as a result of this survey recommendations were made to simplify that procedure. We made some reviews of what the effect of the simplification would be and discovered the over-all effect, as far as the year would go, would be practically negligible, so we changed over to a method where we took 50 per cent of each month's memberships receipt in the income, immediately deferred 50 per cent until the following year.

Is that clear?

Q. Just one more question.

Was that the prior method you used when it was billed 1/24th?

A. In the case of new memberships is when it was billed, [fol. 105] 1953 and prior.

Q. I thought I heard that said.

A. I am sure you did.

Q. You didn't feel that this change would require a request of the Commissioner to change?

A. No, we did not consider this a change in accounting method, of accounting principles, no, sir.

Mr. Kane: That is all. Thank you very much.

Redirect examination.

By Mr. Bomar:

Q. Mr. Baker, would you state whether or not the basic method of accounting employed by the American Automobile Association during the years you were in charge of supervising the audit of their accounts, whether that basic method of accounting was followed consistently?

A. Yes, it was followed consistently.

Mr. Bomar: That is all.

Commissioner Bennett: Thank you, Mr. Baker. You are excused.

(Witness excused.)

Mr. Bomar: Mr. Bell, please.

Whereupon—S. ALEXANDER BELL, a witness produced on behalf of the Plaintiff, being duly sworn by said Commissioner, was examined and testified as follows:

[fol. 106] Direct examination.

By Mr. Bomar:

Q. Please state your full name and address.

A. My name is S. Alexander Bell. I reside in the City of Chicago, at 2150 North Cleveland Avenue.

Q. And what is your occupation or profession?

A. I am a Certified Public Accountant. I am a partner in charge of the insurance department of Peat, Marwick, Mitchell Company.

Q. Please state whether or not you have passed the bar examination.

A. Yes, I was admitted to the bar in 1934.

Q. Please state whether or not you are a member of the Fellow of Actuaries.

A. Yes, I am associated with the Conference of Actuaries in public practice.

Q. Please describe your duties as a partner in the accounting firm of Peat, Marwick, Mitchell Company.

A. As I said, I am a partner in charge of all insurance assignments, which also includes the motor club, throughout the United States, with headquarters in Chicago. In other words, all insurance engagements of any nature, audit, consulting or procedural, tax, et cetera, are under my general supervision.

[fol. 107] Q. Why are motor clubs associated with insurance companies under your general supervision?

A. Well, the firm had two reasons for that: First, we considered the motor club business protects of the nature of insurance and closest to it, and, second, I have had most experience in the form of motor clubs.

Q. Have you as a Certified Public Accountant had experience in auditing the books and records of other motor clubs?

A. Oh, yes.

Q. Would you state whether or not the method of accounting followed by the American Automobile Association is a customary method of accounting in the motor club field?

A. Yes, it is. It is employed by all the motor clubs with which I am familiar.

Q. Mr. Bell, how many years have you practiced public accounting?

A. Well, I started in public accounting in 1929 as an employee of a public accounting firm in Chicago by the name of Winter & Company.

In 1933 I opened my own office under the name of Alexander Bell & Company, from 1933 to 1955. In 1955 I moved my office into Peat, Marwick, Mitchell Company, and became a partner in that firm of Peat, Marwick, Mitchell Company.

[fol. 108] Q. How large was the firm of S. Alexander Bell in terms of merger, in terms of Certified Public Accountants or number of employees?

A. If I remember correctly, we had altogether 46 employees when we merged. That included everybody. We had five CPA's and I don't remember the exact number of staff personnel or clerk personnel, but we had considerable number of them.

Q. Mr. Bell, does the firm of Peat, Marwick, Mitchell &

Company now audit the books and records of the American Automobile Association?

A. Yes, we were engaged to do so in 1957 starting for the year 1958.

Q. Are you familiar with the petition in this case, the Government's answer, the stipulation of facts and testimony which has been given in this case prior to this time?

A. Yes, I familiarized myself with the petition and all the rest of the exhibits.

Q. Will you state whether the accounting methods employed by the American Automobile Association in connection with the advance or prepaid dues are in conformity with generally accepted principles of accounting?

A. Yes, they are definitely in conformity with generally accepted accounting principles.

[fol. 109] Q. And are they not in conformity with generally accepted accounting principles in the motor club field?

A. Yes, the same. They are the principles which all motor clubs that I know of use in allocating their income.

Mr. Bomar: Your Honor, I would like to ask at this point that Mr. Bell, based upon his tremendous experience in the accounting field and with this large accounting firm be recognized as an expert on the subject of accounting in order that he can express opinions in this field.

Mr. Kane: Your Honor, I do not object to his qualifications. In fact, I am sure he is qualified as an expert, but I still take the same position about the expert testimony in this case.

Commissioner Bennett: Very well. Proceed.

By Mr. Bomar:

Q. Mr. Bell, will you state whether in your opinion the method of accounting which the Commissioner seeks to impose upon the Plaintiff in so far as the advance dues are concerned is a proper method of accounting?

A. No, I don't agree with that. I think it is the wrong method of accounting.

Q. And why is it wrong?

A. Because it is in conflict with generally accepted accounting principles which require the segregation as Professor Paton testified here of the financing and revenue [fol. 110] transactions under the method which the Commissioner intended or tried to impose upon the Association. The revenue would be expressed in the wrong rather than in the right way, would not be the correct amount of revenue earned.

Q. Would in your opinion the net worth of the Association on its balance sheets from year to year be overstated unless an account was established representing a liability or dues for which no services had been rendered as of the end of the year?

A. It would be overstated very substantially.

Q. If the Commissioner's method of accounting is successfully imposed would you state whether the American Automobile Association is paying taxes as it earns income or is prepaying them, or what?

A. Under the method which the Commissioner has prescribed for them they are definitely prepaying t[illegible]es on unearned income. In fact, they are prepaying taxes on advances which will never become income to the extent according to these exhibits, probably 98 per cent. In fact, I would say that the rough way of calculating the prepayment of taxes in the case of a motor club would be to take the going tax rate and apply it to the unearned membership dues outstanding as of a given period, because that has been taxed on the gross basis and will be consumed by the expenses which the Association is obligated to incur [fol. 111] in making the service available and for which the deduction will be available only against revenue from future membership for future periods to a very large extent.

Q. Mr. Bell, the testimony in this case is to the effect that Ernst & Ernst were independent auditors of the American Automobile Association from 1931 to 1957 and that the firm of Peat, Marwick, Mitchell & Company are now the independent auditors. Will you or your department be in charge of auditing the books and records of this Association in the future?

A. Yes, sir, I am directly responsible for this engagement and it is being performed right now under my supervision.

Q. Have you changed the method of accounting which has been used by the American Automobile Association?

A. No. We fully agree with the method, and, therefore, will raise no objections.

Q. Mr. Bell, would you certify to the accuracy of the income or profit and loss statement of the American Automobile Association if all advance dues must be reflected in income in the year's receipts?

A. No, we couldn't render an opinion on that. As you say "certify" we use the word "render an opinion." We could not render an opinion because it would not be a proper method of reflecting the income of the Association.

[fol. 112] Q. Would you render an opinion that the balance sheet properly presents the financial picture of the Association unless there were a liability account shown in the balance sheet for prepaid dues for which no services had yet been rendered?

A. No, we could not render an opinion on that because it would be misstating the financial position of the Association.

Mr. Bomar: Thank you, Mr. Bell.

Cross examination.

By Mr. Kane:

Q. I believe you testified, Mr. Bell, that you would not have any income, you would be taxing the gross receipts, is that right, in this case?

A. The effect would be taxing the gross receipts, that's right.

Mr. Kane: That is all.

Redirect examination.

By Mr. Bomar:

Q. How large is the accounting firm of Peat, Marwick, Mitchell & Company?

A. I believe we are the largest accounting firm in the world.

Q. How many offices do you have in the United States and elsewhere?

[fol. 113] A. Well, if my memory serves me correctly, we have fifty in the United States, twelve in Canada, fifteen in South America and sixty-eight elsewhere in the world.

Mr. Bomar: Thank you.

Mr. Kane: Let me ask you a quick question on the Michigan Club. Do you handle that account?

The Witness: No, I don't.

Mr. Kane: Thank you very much.

Commissioner Bennett: You are excused, Mr. Bell.

(Witness excused.)

Mr. Bomar: Mr. McAnly, please.

Whereupon—HERBERT T. MCANLY, a witness produced on behalf of the Plaintiff, being first duly sworn by said Commissioner, was examined and testified as follows:

Direct examination.

By Mr. Bomar:

Q. Please state your full name and address for the record.

A. My name is Herbert T. McAnly. I live at 19101 Shelbourne Road, Shaker Heights, Cleveland, Ohio.

Q. What is your occupation, Mr. McAnly?

A. I am a Certified Public Accountant, a general partner in the firm of Ernst & Ernst. Presently from the operating [fol. 114] standpoint I function as the national director for our management services division. This division is an outgrowth of our former systems division founded more than fifty years ago, and the primary basic objective in the constructive work I do is dealing with companies in improving their systems in order to properly determine income.

Q. Mr. McAnly, you have stated that you are a Certified Public Accountant. In how many states are you licensed to practice as a Certified Public Accountant? In how many states do you have their certificate?

A. I got my original certificate in 1923 in the State of Indiana. In the last thirty-five years I have qualified and received certificates in twenty-four other states including the District of Columbia, and this includes all of the major states such as New York, California, Texas, Pennsylvania, Ohio and Illinois.

Q. Would you please describe your accounting experience? While you have referred to it I would ask that you please describe when you first came into the field and generally how you worked your way up.

Mr. Kane: Excuse me. If you want to shorten this procedure I will admit he is an expert.

The Witness: I will just answer one thing. I started in 1920 and this is finishing my 39th year. I have been [fol. 115] a partner since 1936, for the last 22 years.

Mr. Bomar: While I appreciate the offer to concede that my witness is an expert, in my opinion the degree of eminence of our experts is important in this case and I would ask that I be allowed to continue.

Commissioner Bennett: Do you have a memorandum on it?

Mr. Bomar: I do not.

Mr. Kane: I didn't mean to interrupt that. I was just making this statement, hoping to shorten it.

Mr. Bomar: I have just a few additional questions.

Commissioner Bennett: You are paying for the record. Go ahead.

Mr. Bomar: Would you please read the question and answer so far?

(Question and answer read.)

The Witness: I might add that I presently serve as a member of the five-man Managing Committee of the firm which sets the policies and controls the operations of the firm.

By Mr. Bomar:

Q. Are you a member or have you been a member of any of the committees of the American Institute of Accountants?

A. Yes, for the past six or seven years I have been a member of the Committee on National Defense, and I am now serving as chairman of that committee. The func-
[fol. 116] tion of that committee deals primarily with the development of acceptable accounting principles of suppliers in industry dealing with the Department of Defense, in determining net profit on contracts and Government business and so on.

I am also serving in the capacity as chairman on the Committee on Pricing and Military Accounting for the National Association of Manufacturers, and that committee functions somewhat in the same capacity except it represents an industry group rather than a professional accounting group.

Q. Are you the author of any articles in the field of accounting, or books?

A. Yes. I have written no complete books but over the years I had a great many articles published on various accounting subjects dealing primarily with accounting principles and cost accounting data.

Q. And in which publication would those articles appear?

A. Well, in the Journal of Accountancy, which is the official organ of the American Institute, and in The Controller, which is a national publication of the Controller's Institute and the official bulletin of the National Association of Accountants. It used to be called the National Association of Cost Accountants, but I have a list of those if you wish them.

[fol. 117] Q. Mr. McAnly, based on your many years of experience in the accounting field, would you please state your opinion as to whether or not the accounting method followed by the American Automobile Association with respect to the advance or prepaid dues is in conformity with generally accepted accounting principles?

A. Based upon experience and the things that we have been striving for in trying to determine or define what is proper net income, I believe that the methods employed,

recognizing advances as liabilities rather than income, is in accordance with sound accounting principles.

Q. And, Mr. McAnly, if the Association is compelled to determine its income in accordance with the method of accounting which the Commissioner seeks to impose upon the Association, would its income be fairly reflected in accordance with generally accepted accounting principles?

A. No, it would not be, because the liabilities would be understated and so-called profit overstated.

Q. Mr. McAnly, would you certify to the accuracy of the income or profit and loss statement of the American Automobile Association if the Association follows the method of accounting which the Commissioner seeks to impose upon it?

A. No, it would be impossible to express an opinion, if it is contrary to what you believe and what is accepted as general accounting principles.

[fol. 118] Q. And would the balance sheet of the American Automobile Association fairly reflect its financial position if dues for which no services have been rendered were not considered as a liability of the Association?

A. No, it would not unless the liabilities properly reflect it.

Q. Mr. McAnly, are there any parallel examples derived from your many years of experience as a Certified Public Accountant which might shed light on the accounting issue involved in this case?

A. I might say that the whole principle of accrued accounting embodies the necessity of setting up both assets and liabilities and getting away from using cash transactions as governing the determination of income. Specifically I can recall, for example, in small loan companies or companies that purchase installment commercial paper where a $500 loan is made in which the borrower receives $400, and in the accrued accounting there is a $500 asset due from the borrower.

The $100 which represents the discount and collection expense which has been collected in advance is always set up as a liability or deferred income and taken into income over the period of the loan in relation to the funds that are actually performing the work.

Now, in a sense that is somewhat the reverse of what [fol. 119] we have here, but the principle is the same. In fact, almost any transaction in business which determines income may or may not coincide with the receipt of cash. Actually if it does it is just a coincidence.

A store that has only cash sales would have gross revenue of sales which would agree with the cash receipts, but the completion of the transaction in business where a product is furnished results when the item is taken from inventory on the books and transferred to a receivable, at which time the gross profit is set up, and out of which comes the expenses for the current period.

It seems to me that the whole confusion in this case is trying to determine income from the receipt of cash, dealing with cash rather than taking into consideration the service which is being paid for. In fact, it is not an item that until it became an issue in the case that was referred to, and one or two others, that was ever considered a controversial item in accounting. It is just so obvious that it has been accepted as properly reflecting income by deferring and treating as a liability anything that is paid in advance whether it is a club, department store, or what.

I can just think of hundreds of situations that would point out that there never is any relationship between the receipt of cash. We even have in our defense work or [fol. 120] other construction work, for example, one of the methods of determining the net income is the so-called percentage of completion basis, and even there no attention is paid to the amount of cash that has been paid. It is the engineering determination of what has been completed, and at that time the inventory is taken from inventory and charged against the estimated revenue.

You know, years ago before we had to be so careful about the determination of income, before our Government takes more than half to start with, and accounting, as I understood—it was before my time—was in the affirmative stage. many attempts were made to judge the success of a business as to how much cash was in the bank. It soon became evident there were many other assets as well as liabilities that hadn't been paid, and as a result we have

what we call the accrued accounting method, and how cash paid in advance of a service can be construed as net income subject to tax is just inconceivable from my standpoint.

Mr. Bomar: Thank you, Mr. McAnly.

Mr. Kane: Having heard your opinion, I have no questions.

Commissioner Bennett: Thank you. You are excused.

(Witness excused.)

Mr. Bomar: Plaintiff rests, with one exception, that Plaintiff would be pleased to produce the entire record in [fol. 121] the Michigan case and have it added as a part of this record, certified to by the Clerk of the Tax Court if it is thought that that record would shed any light on the disposition of this case.

Commissioner Bennett: What does the Government think about that?

Mr. Kane: I don't believe that it would, Your Honor. I have been, like him, through the entire record, I think, and the opinions fairly reflect, I believe, what is actually in the record in this case.

Mr. Bomar: There was no accounting testimony of any description in the record, as I understand it. I would be delighted to stipulate with you that the portion of the record that deals with the subject, there were three issues in the case. The accounting issue is only one.

Mr. Kane: I don't know. I am willing to stipulate into the record any portions he feels are material and relevant. I frankly don't see it at the moment, but if he comes to see me and we sit down and discuss it I will certainly consider stipulating further.

Commissioner Bennett: If you do reach such a stipulation I will receive it even though we have the proof closed.

Mr. Kane: I would like, before we close proof, to ask Mr. Cooper one or two questions which I missed this [fol. 122] morning but didn't want to interrupt the expert to get them in.

Commissioner Bennett: Will you come back around, Mr. Cooper?

Whereupon—ARTHUR I. COOPER, a witness recalled on behalf of the Plaintiff, having been previously duly sworn by said Commissioner, was examined and testified further as follows:

Cross examination (Continued).

By Mr. Kane:

Q. I wanted to ask you first if you knew, Mr. Cooper, if the American Automobile Association had any policy of refunding membership dues.

A. I am not familiar with the policy, sir, since it varies in various divisions and is under the jurisdiction of the division managers, but I do know that such refunds are occasionally made, because I see the evidence of them in the ledger.

Q. Maybe this is not a fair question of you, Mr. Cooper, but do you know if the American Automobile Association have a policy of warning a person if he is taking too much service out at any given time, that unless it is cut down he will lose his membership?

A. I am not sure that I can answer that question. I do [fol. 123] know they will send out a notice to the effect that there may have been some excessive use of service, but it is more in the nature of advice to the member that perhaps there is some aspect of his car that needs attention, for example, that his battery needs to be replaced or something of that nature.

I am really not familiar with that, though.

Mr. Kane: I don't believe I have anything else. If we have missed anything I think I can assume Mr. Bomar will give me the same offer of stipulating it in, if it is a fact.

Commissioner Bennett: Do I understand, then, Mr. Kane, that the Government wishes to rest?

Mr. Kane: We would like to have this one leeway if we could, Your Honor, and that is I take it the record will not be closed for a week or two. If Your Honor would have no objection I would like the opportunity to review some of the schedules in some little detail to see if there is anything I feel should be refuted or explained in the record.

But I will not hold up the record any more than ten days or two weeks.

Mr. Bomar: We are very anxious to proceed with this case as quickly as possible. We believe that Mr. Kane should have any opportunity to verify any statistical data from our records which he doesn't think he has verified. [fol. 124] We will cooperate with him in every way to do so, but we are anxious that the matter be disposed of as promptly as possible.

Mr. Kane: We are, too, Your Honor, but I would like to have my agents go over these with me. If we feel we should produce another exhibit it probably would be through one of these revenue agents who has been up there, and this is the table that he made.

Commissioner Bennett: Gentlemen, the proof and rebuttal in this case will be marked closed when Mr. King files the transcript and the exhibits in the office of the clerk. If either counsel wishes to reopen the evidence you may make a motion directed to me showing cause for that and I will consider it and consult with you. I have already indicated that if you have any stipulation, however, that you wish to file, that may be automatically considered part of the record when it is filed with the clerk.

Now, after Mr. King, the reporter, files the transcript and exhibits your time will commence to run for the submission of requested findings of fact. The Plaintiff may have thirty days in which to submit those requests. If that proves to be inadequate for some reason you gentlemen foresee now, let me know and we will work it out.

Defendant's time will start from the time Plaintiff files its requests, and Defendant may have a similar amount of time, and thereafter Plaintiff may have 15 days in which [fol. 125] to comment upon the Defendant's requests if it so desires.

The hearing is closed.

(Whereupon, at 3:40 o'clock p.m., the hearing in the above-entitled matter was closed.)

[fol. 126]

Plaintiff's Exhibit 1

American Automobile Association

Year	Prepaid Dues Received	Deferred Revenue Membership Dues	Percentage
1949	$1,880,641.35	$ 941,976.79	50.1%
1950	2,165,392.96	1,082,393.51	50.0
1951	2,659,502.38	1,323,293.69	49.8
1952	3,160,288.18	1,562,042.23	49.4
1953	3,531,178.67	1,755,407.46	49.7

[fol. 127]

Plaintiff's Exhibit 2

American Automobile Association
Monthly Costs and Expenses
Five Years 1948-1952
(Divisions Only)

Month	Year 1948	1949	1950	1951	1952	Total 1948-1952	Monthly Percent
January	$ 115,837.69	$ 128,764.65	$ 142,957.00	$ 190,958.20	$ 246,135.35	$ 824,652.89	7.48%
February	127,002.09	131,498.47	147,461.00	181,479.00	235,698.03	823,138.59	7.47
March	137,192.11	145,219.23	161,796.00	227,269.00	269,488.00	940,964.34	8.54
April	143,210.62	156,504.80	172,344.00	221,452.00	279,446.00	972,957.42	8.83
May	150,091.89	156,045.54	175,622.00	231,375.00	275,607.00	988,741.43	8.97
June	138,012.68	177,026.02	203,742.00	247,466.00	229,502.00	995,748.70	9.03
July	151,565.00	14[illegible],247.00	160,671.29	223,864.00	296,972.00	981,319.29	8.90
August	127,425.00	144,244.00	168,332.29	230,628.94	274,641.00	945,271.23	8.58
September	126,169.00	139,755.00	163,636.00	208,164.00	261,025.00	898,749.00	8.15
October	112,935.00	134,298.00	170,050.29	217,942.00	268,777.00	904,002.29	8.20
November	111,483.00	121,949.00	161,524.29	193,040.00	244,807.00	832,803.29	7.56
December	146,870.79	114,592.56	184,330.07	240,758.82	226,969.83	913,522.07	8.29
Total	$1,587,794.87	$1,698,144.27	$2,012,466.23	$2,614,396.96	$3,109,068.21	$11,021,870.54	100.00%

[fol. 128]

Plaintiff's Exhibit 3

American Automobile Association
Deferred Revenue—Membership Dues at December 31, 1953
Based on Cost Percentages for Five Years 1948-1952

Month	Prepaid Dues Received	7.48% January	7.47% February	8.54% March	8.83% April	8.97% May	9.03% June	8.90% July	8.58% August	8.15% September	8.20% October	7.56% November	8.29% December	
January	$ 257,698.02	$ 9,637.90	$19,250.04	$22,007.41	$22,754.74	$ 23,115.51	$ 23,270.13	$ 22,935.12	$ 22,110.49	$ 21,002.39	$ 21,131.24	$ 19,481.97	$ 21,363.17	$
February	236,610.67		8,837.41	20,206.55	20,892.72	21,223.98	21,365.94	21,058.35	20,301.20	19,283.77	19,402.07	17,887.77	19,615.02	
March	282,430.08			12,059.76	24,938.58	25,333.98	25,503.44	25,136.28	24,232.50	23,018.05	23,159.27	21,351.71	23,413.45	
April	296,647.02				13,096.96	26,609.24	26,787.23	26,401.58	25,452.31	24,176.73	24,325.06	22,426.51	24,592.04	
May	328,191.75					14,719.40	29,635.72	29,209.07	28,158.85	26,747.63	26,911.72	24,811.30	27,207.10	
June	378,716.30						17,099.04	33,705.75	32,493.86	30,865.38	31,054.74	28,630.95	31,395.58	
July	386,150.87							17,183.71	33,131.74	31,471.30	31,664.37	29,193.01	32,011.91	
August	336,269.66								14,425.97	27,405.98	27,574.11	25,421.99	27,876.75	
September	275,235.54									11,215.85	22,569.31	20,807.81	22,817.03	
October	268,661.48										11,015.12	20,310.81	22,272.04	
November	219,278.02											8,288.71	18,178.15	
December	265,289.26												10,996.24	
Total	$3,531,178.67	$ 9,637.90	$28,087.45	$54,273.72	$81,683.00	$111,002.11	$143,661.50	$175,629.86	$200,306.92	$215,187.08	$238,807.01	$238,612.54	$281,738.48	$

8.20% October	7.56% November	8.29% December	1953 Dues Income in 1953	1953 Dues Deferred at Dec. 31, 1953
$ 21,131.24	$ 19,481.97	$ 21,363.17	$ 248,060.11	$ 9,637.91
19,402.07	17,887.77	19,615.02	210,074.78	26,535.89
23,159.27	21,351.71	23,413.45	228,147.02	54,283.06
24,325.06	22,426.51	24,592.04	213,867.66	82,779.36
26,911.72	24,811.30	27,207.10	207,400.79	120,790.96
31,054.74	28,630.95	31,395.58	205,245.30	173,471.00
31,664.37	29,193.01	32,011.91	174,656.04	211,494.83
27,574.11	25,421.99	27,876.75	122,704.80	213,564.86
22,569.31	20,807.81	22,817.03	77,410.00	197,825.54
11,015.12	20,310.81	22,272.04	53,597.97	215,063.51
	8,288.71	18,178.15	26,466.86	192,811.16
		10,996.24	10,996.24	254,293.02
$238,807.01	$238,612.54	$281,738.48	$1,778,627.57	$1,752,551.10

[fol. 129]

PLAINTIFF'S EXHIBIT 4

AMERICAN AUTOMOBILE ASSOCIATION
MONTHLY COSTS AND EXPENSES
FIVE YEARS 1949-1953
(DIVISIONS ONLY)

Month	Year 1949	1950	1951	1952	1953	Total 1949-1953	Monthly Percent
January	$ 128,764.65	$ 142,957.00	$ 190,958.20	$ 246,135.35	$ 246,597.00	$ 955,412.20	7.46%
February	131,498.47	147,461.00	181,479.00	235,698.03	244,880.00	941,016.50	7.34
March	145,219.23	161,796.00	227,269.00	269,488.00	277,106.00	1,080,878.23	8.44
April	156,504.80	172,344.00	221,452.00	279,446.00	299,836.00	1,129,582.80	8.82
May	156,045.54	175,622.00	231,375.00	275,607.00	292,811.00	1,131,460.54	8.83
June	177,026.02	203,742.00	247,466.00	229,502.00	304,527.00	1,162,263.02	9.07
July	148,247.00	160,671.29	223,864.00	296,972.00	314,934.00	1,144,688.29	8.93
August	144,244.00	168,332.29	230,628.94	274,641.00	292,587.00	1,110,433.23	8.67
September	139,755.00	163,636.00	208,164.00	261,025.00	285,419.00	1,057,999.00	8.26
October	134,298.00	170,050.29	217,942.00	268,777.00	288,170.00	1,079,237.29	8.42
November	121,949.00	161,524.29	193,040.00	244,807.00	258,780.00	980,100.29	7.65
December	114,592.56	184,330.07	240,758.82	226,969.83	271,742.91	1,038,394.19	8.11
Total	$1,698,144.27	$2,012,466.23	$2,614,396.96	$3,109,068.21	$3,377,389.91	$12,811,465.58	100.00%

[fol. 130]

Plaintiff's Exhibit 5

American Automobile Association
Deferred Revenue—Membership Dues at December 31, 1954
Based on Cost Percentages for Five Years 1949-1953

Month	Prepaid Dues Received	7.46% January	7.34% February	8.44% March	8.82% April	8.83% May	9.07% June	8.93% July	8.67% August	8.26% September	8.42% October	7.65% November	8.11% December	
January	$ 290,764.23	$10,845.50	$21,342.09	$24,540.50	$25,645.41	$ 25,674.48	$ 26,372.32	$ 25,965.25	$ 25,209.26	$ 24,017.13	$ 24,482.35	$ 22,243.46	$ 23,580.98	$
February	284,319.95		10,434.54	23,996.60	25,077.02	25,105.45	25,787.82	25,389.77	24,650.54	23,484.83	23,939.74	21,750.48	23,058.35	
March	351,697.47			14,841.63	31,019.72	31,054.89	31,898.96	31,406.58	30,492.17	29,050.21	29,612.93	26,904.86	28,522.66	
April	329,066.99				14,511.86	29,056.62	29,846.38	29,385.68	28,530.11	27,180.93	27,707.44	25,173.62	26,687.33	
May	382,385.38					16,882.32	34,682.35	34,147.01	33,152.81	31,585.03	32,196.85	29,252.48	31,011.45	
June	451,260.81						20,464.68	40,297.60	39,124.31	37,274.14	37,996.16	34,521.45	36,597.25	
July	435,832.93							19,459.94	37,786.72	35,999.80	36,697.13	33,341.22	35,346.05	
August	395,009.70								17,123.66	32,627.80	33,259.82	30,218.24	32,035.29	
September	260,950.54									10,777.26	21,972.04	19,962.72	21,163.09	
October	309,543.51										13,031.78	23,680.08	25,103.98	
November	279,144.44											10,677.28	22,638.61	
December	308,553.22												12,511.84	
Total	$4,078,529.17	$10,845.50	$31,776.63	$63,378.73	$96,254.01	$127,773.76	$169,052.51	$206,051.83	$236,069.58	$251,997.13	$280,896.24	$277,725.89	$318,256.88	$2

8.42% October	7.65% November	8.11% December	1954 Dues Income in 1954	1954 Dues Deferred at Dec. 31, 1954
$ 24,482.35	$ 22,243.46	$ 23,580.98	$ 279,918.73	$ 10,845.50
23,939.74	21,750.48	23,058.35	252,675.14	31,644.81
29,612.93	26,904.86	28,522.66	284,804.61	66,892.86
27,707.44	25,173.62	26,687.33	238,079.97	90,987.02
32,196.85	29,252.48	31,011.45	242,910.30	139,475.08
37,996.16	34,521.45	36,597.25	246,275.59	204,985.22
36,697.13	33,341.22	35,346.05	198,630.86	237,202.07
33,259.82	30,218.24	32,035.29	145,264.81	249,744.89
21,972.04	19,962.72	21,163.09	73,875.11	187,075.43
13,031.78	23,680.08	25,103.98	61,815.84	247,727.67
	10,677.28	22,638.61	33,315.89	245,828.55
		12,511.84	12,511.84	296,041.38
$280,896.24	$277,725.89	$318,256.88	$2,070,078.69	$2,008,450.48

AMERICAN AUTOMOBILE ASSOCIATION
YEAR 1953
DEFERRED REVENUE—MEMBERSHIP DUES
BASED ON AVERAGE MONTHLY COSTS PER MEMBER

Month	Membership	Cost	Cost per Member	Percent	Percent Deferred	Prepaid Membership Dues	12/31/53 Deferred Membership Dues
January	220,435	$ 246,597.00	$ 1.12	7.71%	3.86%	$ 257,698.02	$ 9,947.14
February	223,040	244,880.00	1.10	7.57	11.50	236,610.67	27,210.23
March	224,170	277,106.00	1.24	8.52	19.55	282,430.08	55,215.08
April	226,034	299,836.00	1.32	9.15	28.38	296,647.02	84,188.42
May	228,453	292,811.00	1.28	8.84	37.38	328,191.75	122,678.08
June	230,190	304,527.00	1.32	9.12	46.36	378,716.30	175,572.88
July	233,953	314,934.00	1.35	9.28	55.56	386,150.87	214,545.42
August	236,997	292,587.00	1.23	8.52	64.46	336,269.66	216,759.42
September	239,650	285,419.00	1.19	8.22	72.82	275,235.54	200,426.52
October	242,656	288,170.00	1.19	8.19	81.03	268,661.48	217,696.40
November	244,910	258,780.00	1.06	7.29	88.77	219,278.02	194,653.10
December	246,856	271,742.91	1.10	7.59	96.20	265,289.26	255,208.27
Total	2,797,344	$3,377,389.91	$14.50	100.00%		$3,531,178.67	$1,774,100.96

Prepaid membership dues—1953	$3,531,178.67
Deferred membership dues 12/31/53	1,774,100.9
Membership dues income 1953	$1,757,077.71

[fol. 132] PLAINTIFF'S EXHIBIT 7 86

AMERICAN AUTOMOBILE ASSOCIATION
YEAR 1954
DEFERRED REVENUE—MEMBERSHIP DUES
BASED ON AVERAGE MONTHLY COSTS PER MEMBER

Month	Membership	Cost	Cost per Member	Percent	Percent Deferred	Prepaid Membership Dues	12/31/54 Deferred Membership Dues
January	249,805	$ 280,200	$ 1.12	7.62%	3.81%	$ 290,764.23	$ 11,078
February	252,169	320,193	1.27	8.62	11.93	284,319.95	33,919
March	255,416	348,615	1.37	9.27	20.87	351,697.47	73,399
April	260,795	323,123	1.24	8.41	29.71	329,066.99	97,766
May	263,793	356,652	1.35	9.18	38.51	382,385.38	147,256
June	268,084	377,373	1.41	9.56	47.88	451,260.81	216,063
July	274,467	368,511	1.34	9.12	57.22	435,832.93	249,383
August	279,147	345,792	1.24	8.41	65.98	395,009.70	260,627
September	284,081	341,600	1.20	8.16	74.27	260,950.54	193,808
October	288,222	337,271	1.17	7.95	82.44	309,543.51	255,187
November	291,477	321,321	1.10	7.49	90.04	279,144.44	251,341
December	295,889	270,417	.91	6.21	96.89	308,553.22	298,957
Total	3,263,345	$3,991,068	$14.72	100.00%		$4,078,529.17	$2,088,784

Prepaid membership dues—1954 **$4,078,529**
Deferred membership dues, 12/31/54 [illegible]

[fol. 133]

PLAINTIFF'S EXHIBIT 8

WILLIAM A. PATON
2203 Hill Street, Ann Arbor, Michigan

DATA REGARDING TRAINING AND EXPERIENCE

Educational Background (including technical certificate and honorary degree):

1. Undergraduate work was taken at Michigan State Normal College and University of Michigan.
2. Graduate work at University of Michigan. Received A.M. in 1916 and Ph.D in Economics in 1917. Doctoral dissertation was "Accounting Theory—with Special Reference to Corporate Form of Enterprise".
3. Holds C.P.A. certificate, issued by State of Michigan.
4. Received degree of doctor of letters (Litt.D.) at Lehigh University in 1944.

Teaching Appointments:

1. With minor interruptions has been on faculty at University of Michigan since 1914; was made full professor in 1921.
2. Instructor in economics at University of Minnesota, 1916-17.
3. Visiting professor, University of Chicago, summer of 1924.
4. Visiting professor, University of California, summer of 1921, and academic year 1937-38.
5. Dickinson lecturer, Harvard University Graduate School of Business Administration, April, 1940.
6. Lecturer, Case Institute of Technology, Economics-in-Action Program, July, 1952.
7. Lecturer, Public Utility Executive Program, University of Michigan, summers of 1951-1957.

Prepaid membership dues—1954 $4,078,529
Deferred membership dues 12/31/54 2,085,784

Present Position:

Professor of Economics, College of Literature, Science and the Arts, and Edwin Francis Gay University Professor of Accounting, School of Business Administration, University of Michigan, Ann Arbor, Michigan.

Writing:

1. Books and monographs—

Accountants' Handbook (editor and principal contributor, 1932 and 1943 editions), Ronald Press Co.

Principles of Accounting (with R. A. Stevenson), 1918, Macmillan Co.

Accounting Theory, 1922, Ronald Press Co.

Accounting, 1924, Macmillan Co.

Corporate Profits as Shown by Audit Reports, 1935, National Bureau of Economic Research

Essentials of Accounting, 1938, Macmillan Co.

Advanced Accounting, 1941, Macmillan Co.

Introduction to Corporate Accounting Standards (with A. C. Littleton), 1940, American Accounting Association.

Dickinson Lectures in Accounting (with Sir Laurence Halsey and George O. May), 1941, Harvard University Press.

Contemporary Accounting (with others), 1945, American Institute of Accountants

Asset Accounting (with W.A. Paton, Jr.), 1952, Macmillan Co.

Shirtsleeve Economics, 1952, Appleton-Century-Crofts.

Corporation Accounts and Statements (with W.A. Paton, Jr.), 1955, Macmillan Co.

[fol. 134] Economic Position of United Kingdom, 1919, U. S. Department of Commerce

Requisitioning of the Dutch Shipping, 1919, U. S. War Trade Board

Japanese Steel and Shipping Negotiations, 1919, U. S. War Trade Board

Rationing Agreement with Norway. 1919, U. S. War Trade Board

Trade and Shipping Negotiations with Spain, 1919, U. S. War Trade Board

Rationing and Shipping Negotiations with Sweded, 1919, U. S. War Trade Board

Also numerous problem and case books designed solely for classroom purposes.

2. Articles—

Severity of Trade Cycle in America. In W.H. Hamilton's "Current Economic Problems," 1919.

Theory of the Double-Entry System. Journal of Accountancy, 1917.

Significance and Treatment of Appreciation in the Accounts. Michigan Academy of Science, 1919.

Some Phases of Capital Stock. Journal of Accountancy, 1919.

Transactions Between Partner and Firm. Journal of Accountancy, 1919.

Proprietors' Salaries. Journal of Political Economy, 1920.

Some Current Valuation Accounts. Journal of Accountancy, 1920.

Depreciation, Appreciation, and Productive Capacity. Journal of Accountancy, 1920.

The Drug Store's Overhead. American Druggist, 1920.

Interest During Construction. Journal of Political Economy, 1920.

Methods of Measuring Business Income. Administration, 1921.

Assumptions of the Accountant. Administration, 1921.

The Pro and Con of a Sales Tax. Administration, 1921.

Inventory Valuation. Administration, 1922.

Dividends in Securities. Administration, 1922.

Accounting Training and Economics. Commerce and Administration (University of Chicago), 1922.

Educational Value of Training in Accounting. Papers and Proceedings of American Association of University Instructors in Accounting, 1923.

Simplification of Federal Income Taxation. Certified Public Accountant, 1923.

Tendencies in Accounting Literature. Papers and Proceedings of American Association of University Instructors in Accounting, 1925.

Contribution to Symposium of Opinions on Debt Settlement. American Accountant, 1927.

Distribution Costs and Inventory Values. Accounting Review, 1927.

Accrued Depreciation on Seasoned Properties. Certified Public Accountant, 1927.

Limitations of Financial and Operating Ratios. Accounting Review, 1928.

Special Applications of Discounting. Journal of Accountancy, 1928.

The Work in Accounting at Michigan. American Accountant, 1929.

The Dividend Code. Accounting Review, 1929.

Depreciation and Its Relation to Public Utilities. Accounting Review, 1930.

Economic Theory in Relation to Accounting Valuations. Accounting Review, 1931.

Accounting Problems of the Depression. Accounting Review, 1932.

Working Capital in Public Utility Regulation. Journal of Accountancy, 1932.

"Shoestring" Banking. Certified Public Accountant, 1933.

Shortcomings of Present-Day Financial Statements. Journal of Accountancy, 1934.

Aspects of Asset Valuations. Accounting Review, 1934.

Public Ownership. Public Service Magazine, 1934.

Costs and Profits in Present-Day Accounting. N.A.C.A. Bulletin, 1934.

Valuation of the Business Enterprise. Accounting Review, 1936.

Presentation of Bond Discount. Accounting Review, 1937.

[fol. 135] Comments on "A Statement of Accounting Principles." Journal of Accountancy, 1938.

Is it Desirable to Distinguish Between Various Kinds of Surplus? Journal of Accountancy, 1938.

The Gross Profit Convention. Accounting Forum, 1938.

Deferred Charges and Prepaid Expenses. American Institute of Accountants, 1938.

Objectives of Accounting Research. American Institute of Accountants, 1939.

Recording Revenue on Other Bases than Sales. Accounting Ledger, 1939.

Income and the Inventory Problem. Proceedings of Dedication of Vincent Hall, University of Minnesota, 1939.

Accounting Reports. Institute on Accounting, Ohio State University, 1940.

Last in, First out. Journal of Accountancy, 1940.

Basic Concepts of Property Accounting. Edison Electric Institute Bulletin, 1941.

The Cost Approach to Inventories, Journal of Accountancy, 1941.

Comments on the Cost Principle. Accounting Review, 1942.

Accounting. In Encyclopedia Americana, 1942.

Adaptation of Income Statement to Present Conditions. Journal of Accountancy, 1943.

Classification and Sequences in Financial Statements. American Institute of Accountants, 1943.

Simplification of Federal Tax Administration. Accounting Review, 1944.

Accounting Policies of the Federal Power Commission—A Critique. Journal of Accountancy, 1944.

Responsibilities and Training of the Postwar Accountant. Institute on Accounting, Ohio State University, 1944.

Modern Reports to Stockholders. Controllers Institute of America, 1944.

Transactions Between Affiliates. Accounting Review, 1945.

Current Economic Fallacies. Commercial and Financial Chronicle, 1945.

Accounting Policies and Management. Illinois Society of Certified Public Accountants, 1946.

Cost and Value in Accounting. Journal of Accountancy, 1946.

The Queue Society—Do We Want It? Michigan Alumnus Quarterly Review, 1947.

Restoration of Fixed Assets to the Balance Sheet. Accounting Review, 1947.

What is Actual Cost in Depreciation Accounting? Journal of Accountancy, 1948.

The Accountant and Private Enterprise, Journal of Accountancy, 1948.

Accounting Procedures and Private Enterprise. Journal of Accountancy, 1948.

Depreciation and the Price Level. Accounting Review, 1948.

Some Comments on Group and Sectional Interests. Michigan Alumnus Quarterly Review, 1948.

The Basis for Adequate Financial Reporting. American Management Association, 1948.

Analysis of Financial Statements. Cost and Management, Society of Industrial and Cost Accountants of Canada, 1948.

Why Corporate Profits are Overstated. Commercial and Financial Chronicle, 1948.

Lack of Venture Capital. National Savings and Loan Journal, 1949.

Accounting Problems Relating to Reporting of Profits. Economics and Business Foundation, 1949.

1948 Revision of American Accounting Association's Statement of Principles—Comments on Item 5 under "Expense". Accounting Review, 1949.

The Semantics of Annual Reporting. Annual Report Forum, University of Michigan, 1949.

Measuring Profits under Inflation Conditions. Journal of Accountancy, 1950.

[fol. 136] Overstatement and Misrepresentation of Corporate Earnings under Current Conditions. Republic Steel Corporation, 1952.

Use of Accounting Data in Economic Analysis. Institute on Accounting, University of Kentucky, 1950.

Economic and Accounting Aspects of Pension Plans. Accountants Graduate Study Conference, University of Michigan, 1950.

How Have Stockholders Been Faring? Michigan Business Review, 1952.

The Curb to Public Spending—There's no Such Thing as a Free Lunch. Public Service Magazine, 1953.

Utility Rates Must Recognize Dollar Depreciation (with Howard C. Greer). Public Utilities Fortnightly, 1953.

Premature Revenue Recognition. Journal of Accountancy, 1953.

The Depreciation Deduction—A Neglected Aspect. Michigan Business Review, 1953.

Significance of Depreciation Accounting with Special Reference to Plant Replacements. In Federal Tax Policy for Economic Growth and Stability, Joint Committee on the Economic Report, 1955.

3. Book Reviews—Has written between thirty and forty reviews which have appeared in such publications as Journal of Accountancy, Journal of American Statistical Association, Journal of Political Economy, American Economic Review, Accounting Review, etc.

Addresses:

Has given over 300 addresses before: (1) professional and scientific associations such as American Accounting Association, American Statistical Association, American Economic Association, American Institute of Accountants, Controllers' Institute, Cost Accountants, etc.; (2) trade association meetings, specific company groups, and other business conferences; (3) to civic, church, school and related organizations.

Memberships:

1. Scientific and professional—American Economic Association; American Accounting Association (pres., 1922); Michigan Association of Certified Public Accountants; American Institute of Accountants (member of Council, 1935-37, and member of Committee on Accounting Procedure, 1939-50); National Association of Cost Accountants; American Academy of Arts and Sciences (fellow); Michigan Academy of Science.
2. Honorary—Phi Beta Kappa; Beta Gamma Sigma; Phi Kappa Phi; Alpha Kappa Psi; Beta Alpha Psi.
3. Trustee, Foundation for Economic Education, Inc.
4. Trustee, Earhart Foundation.
5. Ohio State University "Accounting Hall of Fame" (one of three elected in 1950, when this honorary roster was established.

Professional and Business Experience:

1. Trade expert, U. S. War Trade Board, 1918.
2. Chief, Special Assignment Section, Income Tax Unit, U. S. Treasury Department, 1919.
3. Member of firm of Paton & Ross, Certified Public Accountants, Ann Arbor, Michigan, 1926-1936.
4. Director, Kalamazoo Vegetable Parchmant Co., 1952 to date.

[fol. 137] 5. Consultant and expert witness in numerous industrial and public utility rate cases, hearings, and investigations, over a period of forty years. Following is a partial list of such engagements:

Assisted in survey of income accounting of several Michigan electric power companies, 1914-15.

Consultation on values, income, labor costs, etc. for the Detroit United Railways, 1920.

In charge of accounting work in connection with valuation of Kansas City Railways Co. and predecessor companies for United States Court, 1924-25.

Accounting study of Community Traction Company, Toledo, for City of Toledo; also study of plant account for the Company, 1926.

Study of income accounting, with emphasis on depreciation, of Grand Rapids, Grand Haven, and Muskegon Railway Co., and testimony thereon in United States Court, for the receivers, 1927.

Installation of accounting system for electric and water departments of City of Wyandotte, Michigan, 1928.

Study of depreciation accounting of New York Telephone Company, and testimony thereon before the New York Public Service Commission, for the Commission, 1929.

Determination of operating revenues and expenses of International Railway Company applicable to City of Buffalo, and testimony thereon before master in United States Court, for the City of Buffalo, 1929-30.

Study of problem of required working capital and other problems in connection case involving Alabama Power Co., 1930.

Testimony before Committee on Ways and Means, Washington, D.C., on jurisdiction of Board of Tax Appeals in special assessment cases, 1932.

Survey of accounting problems of Board of Road Commissioners of Wayne County, Michigan, 1933.

Study of rate of return in connection with Michigan Bell Telephone case, and testimony thereon before

master in United States Court, for the Michigan Commission, 1932.

Special investigation of revenues and expenses of Kansas City Public Service Company, and testimony thereon before Missouri Commission, for City of Kansas City, Missouri, 1930.

Testimony on price determination under depression conditions, and problems of property revaluation, before the Wisconsin Public Service Commission, for the Commission, on statewide Wisconsin Telephone Company case, 1932.

Compilation of historical cost of property for the Ohio-Edison Co., for Company, in connection with City of Akron rate case before Ohio Public Service Commission, 1932.

Study of earnings and financial ratios of approximately 700 companies, mostly small and medium-sized concerns, for National Bureau of Economic Research, summers of 1931-33.

[fol. 138] Survey of accounting system of State of Michigan for special committee of State Legislature, 1933.

Testimony on joint costs before Michigan Commission, for the Commission, rate case involving Michigan Bell Telephone Co., 1933.

Preparation of financial survey of operations of Tennessee Valley Authority for Arthur Morgan, 1938.

Preparation of memorandum regarding "original cost" for Long Island Lighting Company, 1940.

Testimony on goodwill and fair return before Louisville Court in case involving O'Brien tobacco company, for Mrs. J. A. O'Brien, 1940.

Testimony before an examiner of Securities and Exchange Commission in Washington on treatment of cost of subsidiary stock in the event of merger, for Northern States Power Company, 1941.

Testimony before an examiner of Federal Power Commission, in Madison, Wisconsin, regarding profits of affiliates, intangible assets, and other matters, for St.

Croix Falls, Wisconsin, Improvement Co. and St. Croix Falls, Minnesota, Improvement Co., 1941.

Study of fair rate of return of subsidiary company relative to terms of contract between subsidiary and parent, for Procter & Gamble Co., 1942.

Testimony before an examiner of Federal Power Commission in San Francisco regarding service charges to affiliates, intangibles, and depreciation, for the California-Oregon Power Company, in 1942.

Testimony before a hearing of the Federal Communications Commission in Chicago, on the subject of joint costs, for the City of Detroit, 1942.

Testimony before an examiner of the Securities and Exchange Commission in Philadelphia, on property costs, depreciation, preferred dividend arrearages, etc., for Central Illinois Public Service Co., in 1942.

Study of the earning power of American Power & Light Co. and testimony thereon in hearing before an examiner of the Securities and Exchange Commission in Philadelphia in 1943 and 1944.

Testimony before a joint hearing of the Federal Power Commission and Montana Public Service Commission, in Butte, Montana, regarding property costs, intangibles, and other matters, for the Montana Power Co., in 1944.

Testimony (by deposition) before the Arkansas Department of Public Utilities, regarding property cost, intangibles, depreciation, etc., for the Arkansas Power and Light Co., 1944.

Testimony before an examiner of Securities and Exchange Commission in Philadelphia regarding various accounting practices of Transamerica Corporation, and affiliated companies, for the Corporation, in 1944.

Testimony in a rate hearing before the Public Service Commission of Maryland for the Consolidated Gas Electric Light and Power Company of Baltimore, in Baltimore, regarding classification of property costs, intangibles, quasi reorganization, and other questions, 1945.

[fol. 139] Testimony regarding intangibles, conflicts of regulatory authority, and other matters relating to the affairs of the Arkansas Power & Light Co. before an examiner of the Federal Power Commission in Washington, for the Company, 1948.

Testimony before subcommittee on profits of Joing Committee on the Economic Report regarding effect of inflation and taxes on corporate earnings and position of risk capital, on behalf of American Institute of Accountants, 1948.

Testimony regarding rate of return and related questions for the Consumers power Co. before the Michigan Public Service Co., 1949.

Statement regarding effect of inflation on depreciation and corporate earnings before Presidential Steel Board, on behalf of Republic Steel Co., in 1949, and statement on the same subjects to the Steel Panel of the Wage Stabilization Board, in 1952.

Testimony before Federal Court in Toledo regarding value of the stock of the Fourco Glass Co. on behalf of Blackford Window Glass Co., in 1951.

Testimony before Illinois Commerce Commission in Chicago on the impact of the change in the value of the dollar on the measurement of depreciation cost, on behalf of Peoples Gas, Light & Coke Co., 1952.

Statement to City Council of Dallas, Texas, regarding relation of accounting to rate regulation and the effect of inflation on measurement of costs, on behalf of Southwestern Bell Telephone Co,, 1952.

Statement before Ways and Means Committee, U.S. Congress, regarding measurement of depreciation deduction for tax purposes, 1953.

Testimony before Illinois Commerce Commission regarding effect of inflation on measurement of cost and income, on behalf of Illinois Power Co., 1954.

Panelist for Subcommittee and Tax Policy, Joint Committee on the Economic Report, U. S. Congress, 1955.

Consultant and member of Academic Committee, Advanced Training Center of Internal Revenue Service, 1955-56.

Testimony before Indiana Public Service Commission regarding measurement of depreciation cost, on behalf of Indiana Telephone Corporation, 1956.

Statements to House Post Office and Civil Service re costs of postal operations, in 1956-57.

Testimony for Missouri Water Co. before Missouri Public Service Commission regarding effect of inflation on measurement of cost and income, 1956.

Testimony on effect of inflation on financial measurement before City Council of Jackson, Mississippi, on behalf of Mississippi Valley Gas Co., 1956.

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IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1960

No. 288

AMERICAN AUTOMOBILE ASSOCIATION, Petitioner

v.

UNITED STATES OF AMERICA

CROSS-DESIGNATION OF RECORD FOR PRINTING—
Filed November 21, 1960

The United States cross-designates the following parts of the record in addition to those parts which have been designated by the petitioner:

1. The entire transcript of "Testimony for Plaintiff", except for the testimony of William A. Paton which has already been certified and printed.

2. Plaintiff's exhibits Nos. 1 through 8 (as listed on page ii of the index to "Testimony for Plaintiff").

The above items are parts of the original record in the Court of Claims not previously certified to this Court. The

United States, without objection by petitioner, has moved the Court of Claims to so certify them. In requesting that the above items be permitted in this cross-designation, even though the time for filing such cross-designation has heretofore expired on October 24, 1960, we are authorized to inform this Court that petitioner has no objection to inclusion of these materials in the printed record.

Plaintiff's Exhibit 9 in the Court of Claims contained all relevant parts of the Record in the Tax Court of the United States on the issue of the proper accounting for prepaid [fol. 141] membership dues in *Automobile Club of Michigan* v. *Commissioner*, which was appealed to this Court and reported in 353 U.S. 180, rehearing denied, 353 U.S. 989 (No. 89, Oct. Term 1956). Since the entire record in that case is on file in this Court, the parties have agreed not to reprint plaintiff's Exhibit 9. The parties agree, however, that either or both of them may refer to any part of such record in their briefs and arguments in the present case.

J. Lee Rankin, Solicitor General.

No Objection

Fleming Bomar, Attorney for Petitioner.

IN THE

Supreme Court of the United States

No. .....

AMERICAN AUTOMOBILE ASSOCIATION, *Petitioner*,

v.

THE UNITED STATES OF AMERICA, *Respondent*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

FLEMING BOMAR
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IN THE

Supreme Court of the United States

No.

AMERICAN AUTOMOBILE ASSOCIATION, *Petitioner,*

v.

THE UNITED STATES OF AMERICA, *Respondent*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

PETITION

The American Automobile Association, by Fleming Bomar, its attorney, prays that a writ of certiorari be issued to review the judgment of the United States Court of Claims entered March 2, 1960, dismissing the petition of the American Automobile Association.

REPORT OF THE OPINION DELIVERED BY THE COURT BELOW

The opinion of the United States Court of Claims in this proceeding is reported at — Ct. Cls —; 181 F. Supp. 255. The opinion and findings of fact of the court below are appended hereto in accordance with Rule 23(a) of the rules of this Court.

STATEMENT OF GROUNDS ON WHICH JURISDICTION OF THIS COURT IS INVOKED

The United States Court of Claims entered its judgment in the proceeding below on March 2, 1960. On March 25, 1960, petitioner filed a timely motion for rehearing. On May 4, 1960, petitioner's motion for rehearing was overruled by an order entered by the United States Court of Claims on that date. Jurisdiction of this Court to review the judgment below rests upon 28 U.S.C. Sec. 1254.

QUESTIONS PRESENTED FOR REVIEW

1. Did this Court, in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957), decide that a method of accounting under which prepaid membership dues are reflected as income for tax purposes over the period of membership is, as a matter of law, "artificial" and unacceptable; or did this Court merely hold that the taxpayer there had failed, when challenged by the Commissioner of Internal Revenue, to establish, in his particular case, that the method as used by him was not "artificial?"

2. If a taxpayer proves by uncontradicted evidence, including expert accounting testimony, that its regularly employed method of accounting for prepaid membership dues is "realistic," is in accord with sound accounting principles, and reflects the taxpayer's income clearly, is that taxpayer to be denied the use of such method of accounting for federal income tax purposes by reason of the decision of this Court in *Automobile Club of Michigan, supra*?

STATUTE AND REGULATIONS INVOLVED

The applicable statutes and regulations involved are cited in the Appendix hereto. They are:

Internal Revenue Code of 1939	sections 41, 42(a)
Internal Revenue Code of 1954	sections 446, 451
Treasury Regulations	Regs. 118, sec. 39.41-1, 2 and sec. 39.42-1; Regs. 1.446-1; 1.451-1

A CONCISE STATEMENT OF THE CASE CONTAINING FACTS MATERIAL TO THE QUESTIONS PRESENTED

This is a federal income tax case. Petitioner, the American Automobile Association, seeks to recover from the United States the sum of $207,994.56 with interest according to law representing deficiencies in federal income tax and interest improperly collected by the United States for the calendar years 1952 and 1953.

Petitioner is a corporation with principal offices located at 1712 G Street, N. W., Washington, D. C. Petitioner was incorporated in the year 1910 under the laws of the State of Connecticut and was organized and is operated as a nonstock membership corporation. [R. 72].*

Petitioner's activities are divided into two major parts:

(1) Petitioner is a national organization which renders services to affiliated local automobile clubs and their members and which performs services of a public nature in fields relating to motor and travel. This aspect of petitioner's activities is not involved in this proceeding.

* The references marked "R" are to the consecutively paginated certified transcript of record.

(2) Petitioner operates directly, as divisions, ten local automobile clubs located in various sections of the United States.

A substantial part of the annual gross income of petitioner is derived from dues prepaid for one year in advance received from members of the ten local automobile clubs operated as divisions of petitioner. Petitioner is obligated to provide services for such members over the 12-month period following payment of dues, which services include but are not limited to a complete travel service, emergency road service, bail bond protection, personal automobile accident insurance and similar services. [R. 73].

Petitioner employs the accrual method of accounting in keeping its books and records and in filing its federal income tax returns. Its taxable year is the calendar year. [R. 74].

Under the method of accounting employed by petitioner during the years in issue advance dues collected from members of its divisions were not regarded as income for accounting purposes entirely in the calendar year of receipt but instead were recognized and reflected as income ratably over the 12-month period during which petitioner was obligated to render or make available services to such members—whether or not such period extended beyond the close of petitioner's taxable year. In other words, if a member joined the club on July 1, 1953 and prepaid dues for 12 months in the amount of $15.00, petitioner would reflect $7.50 as income in 1953 and the remaining $7.50 as income in 1954. [R. 76].

The method of accounting employed by petitioner during the years in issue had been used regularly by

petitioner since 1931 and was used both before and after petitioner was required to pay federal income taxes. The method of accounting employed by petitioner during the years in issue is in accord with generally accepted accounting principles and practices, is customarily and generally employed in the motor club field, and reflects its income clearly. [R. 20, 80].

Had the petitioner recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed. [R. 24, 82].

Petitioner's income tax return for the calendar year 1952 reflected net income of $152,975.51. Petitioner's income tax return for the calendar year 1953 reflected net income of $352,125.84. The 1954 tax return reported a net operating loss in the amount of $290,186.04. [R. 74].

Upon audit of petitioner's federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue determined not to recognize the method of accounting employed by petitioner during the calendar years 1953 and 1954, which is the issue in this proceeding. The net effect of such determination was to increase petitioner's 1953 net income to $481,557.59 and reduce petitioner's 1954 net operating loss to $14,412.49. [R. 75].

As a result of the adjustments described above, the Commissioner of Internal Revenue asserted deficiencies in income tax for the calendar years 1952 and 1953, which were paid by petitioner in May, 1956. Petitioner filed timely claims for refund within two years and commenced suit July 8, 1958. [R. 76].

JURISDICTION OF THE COURT BELOW

The jurisdiction of the United States Court of Claims in the proceeding below rested upon 28 U.S.C. Sec. 1491.

REASONS RELIED ON FOR ALLOWANCE OF THE WRIT

There are two basic reasons why a writ should be allowed in this case.

1. The decision of the Court of Claims is in direct conflict with the recent decision of the Court of Appeals for the Second Circuit in *Bressner Radio, Inc.* v. *Commissioner*, 267 F. (2d) 520 (1959), involving the identical issue; and

2. An important question of federal income tax law is involved which has not been, but should be, decided by this Court; namely, whether items of prepaid income can be accounted for under federal tax laws in accordance with sound accounting principles. The confusion on this point arises from the failure of some lower courts to interpret correctly this Court's decision in *Automobile Club of Michigan* v. *Commissioner, supra.*

ARGUMENT

In deciding whether a petition for certiorari should be granted in this case, the first question this Court will undoubtedly ask is, "Did we not dispose of this issue in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957)?" Petitioner respectfully suggests the answer is, "No!"

One of the three issues involved in the *Automobile Club of Michigan* case did concern the method of accounting employed by that club with respect to prepaid membership dues. The Commissioner of Internal Revenue had disapproved the use of a method of accounting which reflected prepaid membership dues as income ratably over the period of a membership. The Commissioner argued that the "claim of right" doctrine required all prepaid dues to be reported as income entirely in the year of receipt, irrespective of principles of sound accrual accounting. While this Court referred to the "claim of right" doctrine, it seems clear the court did not ground its decision on that doctrine. Instead, in a 5-3 decision, this Court sustained the action of the Commissioner, the majority opinion explaining the reasons for the decision as follows:

> "The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member . . . . We cannot say, *in the circumstances here*, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits." (353 U.S. at 187) (Italics supplied).

The language quoted above has been interpreted by the lower courts in two vastly different ways, and much confusion exists as to its meaning.[1]

Petitioner's interpretation—and petitioner was familiar with the decision prior to the commencement of this litigation—was that the court's opinion by implication would allow a motor club to defer prepaid membership dues in accordance with sound accounting principles if a motor club could establish that its method of deferral bore a reasonable relationship to the future expenses which the club would incur in serving its members—and clearly reflected its income. In other words, if income and expense were matched, which is the essence of accrual accounting, deferral of prepaid dues would be permitted. By contrast, the Tax Court since *Automobile Club of Michigan* has reached the extreme conclusion that under no circumstances may an item of prepaid income ever be reported for tax purposes later than the year of receipt.[2]

The issue stated another way is: Was the Supreme Court decision in *Automobile Club of Michigan* grounded on a rule of law which overrides the governing statutes requiring the use of sound accounting or was the decision on the accounting issue based solely upon the facts which existed in that case? Since the record in the *Michigan Club* case was so devoid of evi-

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[1] A few of the most recent cases in this area are: *Bay Shore Gardens, Inc.* v. *Commissioner*, 267 F. (2d) 55 (2d Cir. 1959); *Bressner Radio, Inc.* v. *Commissioner*, 267 F. (2d) 520 (2d Cir. 1959); *Automobile Club of New York*, 32 T.C. 906 (1959); *Mark E. Schlude*, 32 T.C. 1271 (1959); *New Jersey Automobile Club* v. *U. S.*, 181 F. Supp. 259 (Ct. Cl. 1960); *Automobile Club of Southern California* v. *U. S.*, 60-1 USTC, ¶ 9274 (S.D. Cal. 1960); *Streight Radio & Television, Inc.*, 33 T.C. 127 (1959).

[2] *Automobile Club of New York*, 32 T.C. 906 (1959).

dence on the accounting issue (not one certified public accountant was called to testify) and since this Court distinguished on their facts two cases involving the same or a similar legal principle,[3] petitioner's interpretation is that this Court decided the accounting issue solely on the facts or lack of facts in that case.

If this Court in *Automobile Club of Michigan* intended to lay down a rule of law that, *irrespective of sound and accepted accounting practices,* no taxpayer who receives money in advance of the rendition of services for which the money is paid can ever postpone the recognition as income of such money beyond the taxable year of receipt, then petitioner concedes that its petition for writ of certiorari should be denied. This would be a very sweeping rule indeed, and it is hard to believe that this interpretation of *Automobile Club of Michigan* is correct.

The method of accounting employed by petitioner with respect to prepaid dues income, although undeniably similar to that employed by the Michigan Club, has *here* been established as accurate, since both prepaid dues and prepaid expenses are accounted for ratably over the period of a membership and since the method used clearly reflects its income in the opinion of the accounting profession. Commissioner Bennett of the Court of Claims, who heard petitioner's testimony, made the following findings of fact: [See R. 12-27].

(a) "Funds representing advances from customers or members of an organization are not income

[3] *Beacon Publishing Company* v. *Commissioner*, 218 F. (2d) 697 (10th Cir. 1955); *Schuessler* v. *Commissioner*, 230 F. (2d) 722 (5th Cir. 1956).

at the time received but constitute a liability until such time as goods are delivered or services are rendered or made available in accordance with the advance payment agreement. It is an undisputed principle of accounting that no revenue or income can emerge until goods are delivered or until services are rendered." (Finding 23).

(b) The petitioner's method of accounting with respect to prepaid dues income was in accord with generally accepted accounting principles and was the most realistic and practical method of accounting that it could have employed. (Findings 22, 25, 29).

(c) The taxpayer's method of accounting clearly reflected its income. (Finding 33).

(d) The Government's method of accounting is contrary to generally accepted accounting principles and practices. (Finding 24).

(e) The Government's method of accounting results in an overstatement of petitioner's surplus account in the amount of $1,358,003.10 as of December 31, 1953 and an overstatement of surplus in the amount of $1,634,840.81 as of December 31, 1954. (Finding 24).

(f) The Government's method of accounting for prepaid dues income does not reflect taxpayer's net income accurately. (Finding 24).

(g) No reputable certified public accountant would certify to the accuracy of petitioner's profit and loss statements or balance sheets if the Government's method of accounting for prepaid dues is forced upon petitioner. (Finding 24).

Some of these findings were not included by the Court of Claims in its findings of fact, but it did find the following facts:

"The plaintiff's costs for servicing members were substantially in proportion to membership from year to year with reasonable constancy from month to month. . . ." (Finding 30). [R. 83].

"The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices . . . ." (Finding 22). [R. 80].

"Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed." (Finding 26). [R. 82].

Despite the Commissioner's findings of fact, and for that matter its own findings, the Court of Claims held that, as a matter of law, petitioner's method of accounting was artificial for tax purposes because this Court had held a similar method to be artificial in *Automobile Club of Michigan*. The effect of this decision is to say that a taxpayer is foreclosed from establishing that his method of accounting is not artificial, that it clearly reflects his income, and that it is based on sound accounting principles.

The United States Court of Appeals for the Second Circuit has construed *Automobile Club of Michigan* in a manner diametrically opposed to the construction of that case adopted by the Court of Claims in the

case at bar. In *Bressner Radio, Inc.*, 267 F. (2d) 520 (1959), decided by the Court of Appeals for the Second Circuit two years subsequent to this Court's decision in *Automobile Club of Michigan, supra,* the issue involved was identical in principle to that presented in the case at bar. The taxpayer in *Bressner Radio, Inc.* sold television sets. It agreed to service the sets only if a separate service contract was entered into by the purchaser. The cost of the service contract was prepaid for twelve months. Taxpayer's obligation was to render whatever services were necessary to keep the television set in repair and such services, other than installation, were rendered only upon the request of the owner of the set. In keeping its books and records and in filing its tax returns the taxpayer recognized prepaid television service fees as income ratably over the period of the contract rather than entirely in the year of receipt. It proved, however, that its method of accounting was in accord with sound accounting principles and clearly reflected its income. Upon the basis of the facts established by the taxpayer, the Court held for the taxpayer. In referring to the decision of this Court on the accounting issue in *Automobile Club of Michigan, supra,* it stated:

> "It is apparent from the decision of the majority that at least for purposes of the decision of the case it assumed that a realistic deferral would have been permissible, and found only that no realistic deferral was made." 267 F. (2d) at 526.

The Court then went on to conclude that the taxpayer before it had not used an artificial method of deferral, stating:

> "Drawing on its experience with thousands of contracts it was demonstrated that it was subject

> to a reasonably uniform demand for services so that it could and did anticipate that the expenses incident to the performance which alone would entitle it to regard the sum received as earned would be distributed across the life of the contract. It therefore deferred revenues until they were earned and thus matched them with foreseeably related expenses which is the essential purpose of accrual accounting. *United States* v. *Anderson*, 1926, 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347." 267 F. (2d) at 528.

Since the petitioner in the case at bar established by clear and uncontradicted evidence that its method of accounting was not artificial and did clearly reflect its income, it would certainly have prevailed under the rule of law spelled out by the Court of Appeals for the Second Circuit in *Bressner Radio, Inc.* v. *Commissioner, supra.* Thus, that decision and the decision in the case at bar are in direct conflict. Furthermore, this conflict relates to an extremely important issue with respect to which much confusion exists in the courts below.[4] It should also be noted that, in the opinion of commentators and writers in the field, this crucial question has never been decided on its merits by this Court.[5]

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[4] See cases cited in n. 1, *supra.*

[5] "The Supreme Court implied that a realistic deferral would have been permissible and found only that no realistic deferral had been made. Thus, the issue of the inclusion of prepaid income, *properly allocated* to future periods, in current taxable income was not passed upon by the Supreme Court." Behren, "Prepaid Income Accounting Concepts and the Tax Law," 15 Tax L. Rev. 343, 359, 360 (1960). See also Costigan, "Accrual Accounting in the Courts of Appeals," 38 Taxes 339, 348-349 (1960); Jacobs, "Chang-

With respect to this important conflict it would appear clear from the statutory provisions involved that this Court, in, *Automobile Club of Michigan, supra*, could not have meant what the Court of Claims below has said it meant, but on the contrary, must have meant what the Court of Appeals for the Second Circuit in *Bressner Radio, Inc., supra,* said it meant.

Section 446 of the Internal Revenue Code of 1954 states, as did its predecessor, Section 41(a) of the Internal Revenue Code of 1939, that

> "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income and keeps his books."

Exceptions to this general rule are provided for if no method of accounting has been regularly used by the taxpayer or if the method used does not clearly reflect income. The Commissioner of Internal Revenue is granted the power to change a taxpayer's method of accounting only if one of these two exceptions is applicable.

Similarly, Section 451 of the 1954 Code states as did its predecessor, Section 42 of the 1939 Code, that

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ing Attitudes Toward Accrual Concepts," N.Y.U. 16th Inst. on Fed. Tax, 579, 595 (1958).

In Note, "Taxation of Prepaid Income: A Temporary Solution," 67 Yale L.J. 1425, 1440 (1958) it is stated:

"... Thus, an automobile club could defend its method of allocating any individual's dues by demonstrating the average services requested by a member for a particular period."

See also Freeman, "Tax Accrual Accounting for Contested Items," 56 Mich. L. Rev. 727, 730-731, 737 (1958); Hoffman, "Accounting Treatment Counts in Determining Net Taxable Income," 35 Taxes 918, 921 (1957); Note, "Taxation: Prepaid Income Deferrals and the 'Claim of Right' Doctrine," 1960 Duke L.J. 127, 131-134; Note, 59 Col. L. Rev. 942, 944 (1959).

> "Any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless under the method of accounting used in computing taxable income such amount is to be properly accounted for as of a different period.*" (Italics supplied).

The statutory language clearly states that the time at which items of gross receipts shall be included in gross income is determined by reference to the taxpayer's method of accounting. It seems obvious that a method of accounting is one which meets the approval of the accounting profession as clearly reflecting income. The Treasury's own regulations interpreting the statutory provisions quoted above reinforce this conclusion. These regulations state:

> "A method of accounting which reflects a consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions in that trade or business would ordinarily be regarded as clearly reflecting income, providing all items of gross income are treated consistently from year to year." Treasury Regulations, Section 1.446-1(a)(2).

Once again deference to the accounting profession is obvious.

The Regulations under the 1939 Code contain the following statement:

> "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income." Treasury Regulations, Section 118, Section 39.41-2(a).

Petitioner submits that it is clear beyond doubt that a taxpayer should be entitled to use a method of ac-

counting if he establishes that such method clearly reflects his income and, in his situation, is not "artificial" but is "realistic," and taxpayers should not be precluded from using such method on the ground that this Court in *Automobile Club of Michigan* v. *Commissioner, supra* has ruled out such a method as a matter of law.

In summary, the grounds within this Court's rules upon which petitioner relies in this petition for a writ of certiorari are:

1. The decision below is in direct conflict with that of the Court of Appeals for the Second Circuit in *Bressner Radio, Inc.* v. *Commissioner, supra.*

2. A decision by this Court is needed to clarify an important question of federal income tax law which arises out of the diversity of interpretations by the lower courts of this Court's decision in *Automobile Club of Michigan* v. *Commissioner, supra.*

Moreover, it should be noted that the decision below is inconsistent with the primary findings of fact made by the Court of Claims. Such a situation calls for the exercise of this Court's power of supervision as in *United States* v. *Penn Foundry Manufacturing Co., Inc.*, 337 U.S. 198 (1949).

Respectfully submitted,

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APPENDIX

Internal Revenue Code 1939

"SEC. 41. GENERAL RULE.

"The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *"

"SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

"(a) General Rule.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *"

Regulations 118

"§ 39.41-1 *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a

manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

"39.41-2 *Bases of computation and changes in accounting methods.* (a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of 'paid or accrued' and 'paid or incurred.' All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. • • •

• • • •

"§ 39.42-1 *When included in gross income*—(a) *In general.* Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. See §§ 39.41-1 to 39.41-3, inclusive. • • •"

Internal Revenue Code of 1954:

"SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

"(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

"(c) Permissible Methods.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;
(2) an accrual method;
(3) any other method permitted by this chapter; or
(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

"(d) Taxpayer Engaged in More Than One Business.—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

"(e) Requirement Respecting Change of Accounting Method.—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

"SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

"(a) General Rule.—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

"(b) Special Rule in Case of Death.—In the case of the death of a taxpayer whose taxable income is computed under an accrual method of accounting, any amount accrued only by reason of the death of the taxpayer shall not be included in computing taxable income for the period in which falls the date of the taxpayer's death."

Regulations Promulgated Under the 1954 Code:

"§ 1.446-1 (T.D. 6282, filed 12-24-57.)

"General rule for methods of accounting—(a) General rule. (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term 'method of accounting' includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes

his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

"(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

"(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461 and the regulations thereunder.

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"§ 1.451-1 (T.D. 6282 filed 12-24-57.)

"General rule for taxable year of inclusion—(a) General rule.—Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method

of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income it attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and § 1.706-1(a). If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom."

In the United States Court of Claims

No. 311-58

(Decided March 2, 1960)

AMERICAN AUTOMOBILE ASSOCIATION v. THE UNITED STATES

Mr. Fleming Bomar for the plaintiff. *Messrs. Joseph E. McAndrews* and *Irvine, Phillips & Barker* were on the brief.

Mr. Jerry M. Hanovit, with whom was *Mr. Assistant Attorney General Charles K. Rice*, for the defendant. *Messrs. James P. Garland* and *Lyle M. Turner* were on the brief.

OPINION

JONES, *Chief Judge*, delivered the opinion of the court:

The plaintiff, a motor club, seeks to recover Federal income taxes and assessed interest paid for the calendar years 1952 and 1953. The issue to be decided here involves the tax treatment to be accorded the prepaid income of an accrual basis taxpayer. The problem arises because club membership dues are paid to the taxpayer for 12 months in advance.

Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel. In addition to its activities as a national organization, the plaintiff operates directly, as divisions, ten local automobile clubs. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs operated as divisions of the plaintiff.

Plaintiff provides services for the members of the local divisions over the 12-month period following payment of

dues. These services, although not completely uniform, generally included the following: (a) A travel service which included trip planning, tour books, accommodation directories, maps and recommended routes; (b) emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs; the road service was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions; (c) bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen; (d) personal automobile accident insurance; (e) a theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car; (f) in addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

The prepaid dues collected from members of its divisions were deposited in plaintiff's bank accounts with no restrictions as to their use for any of its corporate purposes. However, the dues upon collection were reflected in a liability account designated "Deferred Revenue—Membership Dues." Thereafter, a pro rata part of the dues was removed from the liability account and reflected in an "income" account. Dues collected from members who joined in the month of January were recognized as income in January only to the extent of 1/24 (a half of 1/12) of such collections, on the assumption that the average or mean date of the January collections would be the middle of the month.[1] Thereafter, 1/12 of the dues collected in January was taken out of the liability account and credited to income in each of the following 11 months (i.e., February through December). The remaining 1/24 of the dues collected in January was kept as a liability in the "Deferred Revenue—Membership Dues" account on December 31, but was subsequently recognized as income for January of the following year.

[1] Plaintiff's taxable year was the calendar year.

Dues collected in each of the other months of the calendar year were treated in the same manner. That is, 1/24 of each month's collections was recognized as income in the first month of membership, 1/12 of the amount paid was recognized as income in each of the following eleven months, and the remaining 1/24 was allocated to income in the month when membership expired. Commencing in 1954, the plaintiff, in order to simplify internal accounting detail, changed its procedure in the monthly accounting for dues by assigning 50 percent of the dues to income for the current year and allocating the other 50 percent as a liability which matured as income in the following tax year.

In preparing its income tax returns for the years in suit, plaintiff, an accrual basis taxpayer, excluded from the income received in each year that portion of membership dues which remained in the liability account ("Deferred Revenue, Membership Dues") at the end of the taxable year. It thus treated dues as income ratably over the 12-month period of membership, whether or not such period extended beyond the close of its taxable year.

Expenses which plaintiff considered to fall within the category of prepaid membership costs, e.g., salesmen's commissions and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were not deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that dues were recognized as income.

The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,237,813.41, representing $1,562,042.23 of prepaid dues collected in 1952 but not recognized as income until 1953, plus $1,675,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,107.46 of advance dues collected in 1953 but not recognized as income until 1954, plus $2,039,564.74 of dues collected in 1954 and recognized as income in that year.

Plaintiff claimed that as a result of a 1954 net operating loss in the amount of $289,987.67, it was entitled to a net operating loss carryback *deduction* in 1952 in the amount

of $154,411.11, and a net operating loss carryback *deduction* in 1953 in the amount of $135,556.56. Upon examination of the plaintiff's Federal income tax returns for the calendar years 1952, 1953, and 1954, the Commissioner of Internal Revenue disallowed plaintiff's deferral of income from one year to another, for years subsequent to 1953, thereby increasing plaintiff's 1954 net operating income from $353,279.09 to $481,557.59 and reducing plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49. The net effect of the Commissioner's determination was to reduce plaintiff's net operating loss carryback deduction to $14,412.49 in 1952 and to eliminate entirely any net operating loss carryback deduction in 1953.

The issue to be decided by this court is whether the Commissioner of Internal Revenue correctly determined that plaintiff's method of accounting—with respect to dues received from members of its divisions—does not clearly reflect plaintiff's income within the meaning of § 41 of the Internal Revenue Code of 1939 and § 446 of the Internal Revenue Code of 1954. Section 41 required that "the net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books . . . but . . . if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income . . . ."[2]

The Commissioner of Internal Revenue disallowed the deferral of income from one year to another on the ground that prepaid dues received under a "claim of right," without restriction as to their disposition, represents income in the year of *receipt* and should be taxed in that year regardless of the method of accounting employed by the taxpayer. This position is based on the claim of right doctrine enunciated by the Supreme Court in *North American Oil Co.* v. *Burnet*, 286 U.S. 417, 424 (1932). It is of course fairly obvious that, once it is determined that prepaid income is

[2] To the same effect, § 446, Int. Rev. Code of 1954, provides that: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." However, "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

required to be included in income in the year of receipt under the claim of right doctrine, it would necessarily follow that any other method of reporting would not "clearly reflect the income."

The opposite view, advanced by the plaintiff—that the claim of right doctrine does not relate to the question whether items that admittedly belong to the taxpayer may be attributed to a taxable year other than that of receipt in accordance with principles of accrual accounting—has been succinctly presented by Mr. Justice Harlan, dissenting in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 191–192 (1957).[8]

However, we do not find it necessary to resolve this issue, since we agree with the Government's contention that the method of treatment of prepaid automobile club membership dues employed by the plaintiff was dealt with by the Supreme Court in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, rehearing denied, 353 U.S. 989 (1957), and was held to be, at least for Federal income tax purposes, "purely artificial." In the *Automobile Club of Michigan* case prepaid membership dues were credited upon receipt to an account carried as a liability and designated "Unearned Membership Dues." - "*During the first month of membership and each of the following eleven months one-twelfth of the amount paid . . .* [was] *'credited to an account designated 'Membership Income.'* This method of accounting was followed by petitioner [a motor club] from 1934. The income from such dues reported by petitioner in each of its tax returns for 1943 through 1947 was the amount credited in the year to the 'Membership Income' account." 353 U.S. at 188. (Emphasis supplied.)

The Commissioner of Internal Revenue had determined that this method of accounting—which is essentially the same method used by the plaintiff in the case at bar—did not clearly reflect income. The Supreme Court, in affirming the action of the Commissioner, stated (353 U.S. at 189–190):

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[8] "[The claim of right] doctrine, it seems to me, comes into play only in determining whether the treatment of an item of income should be influenced by the fact that the right to receive or keep it is in dispute; it does not relate to the entirely different question whether items that admittedly belong to the taxpayer may be attributed to a taxable year other than that of receipt in accordance with principles of accrual accounting." (*Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 191–192 (dissenting opinion) (1957).)

> The petitioner does not deny that it has the unrestricted use of the dues income in the year of receipt, but contends that its accrual method of accounting clearly reflects its income and that the Commissioner is therefore bound to accept its method of reporting membership dues. We do not agree. * * * *The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member.* Section 41 vests the Commissioner with discretion to determine whether the petitioner's method of accounting clearly reflects income. We cannot say, in the circumstances here, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits. See *Brown* v. *Helvering*, 291 U.S. 193, 204-205. [Emphasis supplied.]

Although it would appear that *Automobile Club of Michigan* does not expressly rule out deferral of income,[4] we are constrained to interpret this language as a rejection by the Supreme Court of the accounting method advanced by plaintiff in the case at bar.

We are influenced in our decision by the language used by the Court to distinguish on their facts *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697 (10th Cir. 1955) (deferral of prepaid magazine subscription income) and *Schuessler* v. *Commissioner*, 230 F. 2d 722 (5th Cir. 1956) (reserves set up to meet future costs):

> In *Beacon*, performance of the subscription, in most instances, was, in part, *necessarily* deferred until the publication dates after the tax year. In *Schuessler*, performance of the service agreement required the taxpayer to furnish services at *specified times* in years subquent to the tax year. In this case [as in the case at bar], substantially all services are performed only upon a *member's* demand and the taxpayer's performance was not related to *fixed dates* after the tax year. We express no opinion upon the correctness of the decisions in *Beacon* or *Schuessler*.[5]

But regardless of the underlying basis for the Court's rejection of "the pro rata allocation of the membership dues

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[4] See *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. at 192-193 (dissenting opinion).

[5] *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. at 189, fn. 20. (Emphasis supplied.)

in monthly amounts" as "purely artificial," we feel constrained by the decision in *Automobile Club of Michigan* to reject that same method of accounting for tax purposes in the case at bar.*

The plaintiff is therefore not entitled to recover and its petition will be dismissed.

It is so ordered.

LITTLETON, *Judge (Ret.)*; LARAMORE, *Judge*, and MADDEN, *Judge*, concur.

WHITAKER, *Judge*, concurring:

From the enactment of the Corporation Excise Tax Act of 1909 and the first income tax act in 1913, it has been universally supposed that in order to "clearly reflect income" the taxpayers' accounting method must treat as gross income amounts received or accrued in the taxable year, with certain exceptions specified in the Code. The income under consideration here was received in plaintiff's taxable year. Plaintiff's method of accounting treats a portion of that income as not having been received in the taxable year and, thus, does not clearly reflect its income, unless it comes within the statutory exceptions. Those exceptions are, for example, reserves for depreciation, obsolescence, and depletion, and, in the case of insurance companies prepaid premium reserves. The statute does not allow the deduction of reserves to anticipate expenses of meeting the demands of plaintiff's membership. What plaintiff, in effect, seeks to do is to deduct such a reserve from the income it received within the taxable year.

I also concur in the majority opinion.

FINDINGS OF FACT

The court, having considered the evidence, the report of Trial Commissioner Marion T. Bennett, and the briefs and argument of counsel, makes findings of fact as follows:

1. Plaintiff is a corporation with its principal office at 1712 G Street, Northwest, Washington, D.C. Plaintiff was incorporated in the year 1910 under the laws of the State of

*Cf. *Brosnick Radio, Inc.* v. *Commissioner*, 267 F. 2d 529, 528, 529 (2d Cir. 1959); *Automobile Club of Southern California* v. *United States*, Civil No. 1169-58, S. D. Cal., January 22, 1960.

Connecticut and was organized and is operated as a non-stock, membership corporation.

2. Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel.

3. In addition to the activities described in paragraph two above, plaintiff operates directly, as divisions, the following local automobile clubs:

District of Columbia Division of AAA (Metropolitan area, Washington, D. C.)
Louisiana Division of AAA (entire state)
Massachusetts Division of AAA (part of state)
New Hampshire Division of AAA (entire state)
New Mexico Division of AAA (entire state)
North Florida Division of AAA, South Florida Division of AAA (part of state)
Texas Division of AAA (part of state)
Wisconsin Division of AAA (entire state)
Wyoming Division of AAA (entire state)

4. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs described in paragraph three and operated as divisions of plaintiff. Plaintiff provides services for such members over the 12-month period following payment of dues. The services provided by plaintiff for the members of its divisions during the years in issue, although tending to be parallel, were not completely uniform and included the following: (a) A complete travel service which included trip planning, tour books, accommodation directories, maps and recommended routes. (b) Emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs. The road service was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions. (c) Bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen. (d) Personal automobile accident insurance which included hospitalization, personal injury and death benefits on a sliding scale in the event of a motoring accident. The plaintiff contracted for the insurance on a group basis and paid the premiums on the group policies.

(e) A theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car. In addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

5. In order to make available and provide for the members of its divisions the services which plaintiff provides, plaintiff during the years in issue owned or rented offices in 39 to 41 different geographical locations and had on its divisions' payroll 495 employees in December 1953 and 603 employees in December 1954.

6. Plaintiff, commencing with the calendar year 1943, has been required to file Federal income tax returns and to pay Federal income taxes on its net income. Its Federal income tax returns are filed with the District Director of Internal Revenue, Baltimore, Maryland. The plaintiff's taxable year is the calendar year.

7. Plaintiff employs the accrual method of accounting in keeping its books and records and in filing its Federal income tax returns.

8. Plaintiff, within the time prescribed by law, filed Federal income tax returns with the District Director of Internal Revenue, Baltimore, Maryland, for the calendar years 1952, 1953 and 1954. The 1952 return reported a net income of $152,975.51, the 1953 return reported a net income of $35,125.86, and the 1954 return reported a net operating loss in the amount of $289,186.04.

9. Upon examination of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue made several minor adjustments which are not in issue in this proceeding, the net effect of which was to increase plaintiff's 1952 net income to $154,411.11, to increase plaintiff's 1953 net income to $353,279.09, and to reduce plaintiff's 1954 net operating loss to $289,867.67.

10. Plaintiff claimed that as a result of its 1954 net operating loss in the amount of $289,867.67, it was entitled to a net operating loss carryback deduction in 1952 in the

amount of $154,411.11, and a net operating loss carryback deduction in 1953 in the amount of $135,556.56.

11. Upon examination of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue also determined not to recognize the method of accounting employed by plaintiff in computing its income derived from prepaid dues collected from members of its divisions during the calendar years 1953 and 1954, which is the issue in this proceeding. The net effect of such determination was to increase plaintiff's 1953 net income from $353,279.09 to $481,557.59 and to reduce plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49, with the further result that the Commissioner reduced plaintiff's net operating loss carryback deduction from $154,411.11 to $14,412.49 in 1952 and eliminated entirely any net operating loss carryback deduction in 1953.

12. The Commissioner of Internal Revenue determined the increase of plaintiff's income for 1953 by $128,278.50 and the reduction of plaintiff's loss for 1954 by $275,555.15 was in the following manner:

	1953 Adjustments	1954 Adjustments
Reserve for unearned and deferred income Dec. 31 of current year	$1,756,485.46	$2,039,264.43
Less reserve for unearned and deferred income Dec. 31 of prior year	1,562,042.23	1,756,485.46
Difference	194,443.23	282,778.97
Less		
Prepaid commissions		
Dec. 31 of current year	398,482.36	405,708.15
Dec. 31 of prior year	332,317.63	398,482.36
Difference	66,164.73	7,225.79
Net additional income determined for the current year	128,278.50	275,555.18

All of the foregoing items are reflected in the plaintiff's balance sheets as of December 31 for the years involved, which were filed with its income tax returns for 1953 and 1954. The liabilities contain the account UNEARNED AND DEFERRED INCOME, and the assets contain the account PREPAID COMMISSIONS, but the latter account is not involved in the

items labeled prepaid commissions in the above tabulation. The deduction items employed by the Commissioner of the Internal Revenue Service represent plaintiff's asset account for prepaid membership costs. The plaintiff's assets for 1954 do not reflect any amount for prepaid membership costs, but its liabilities for unearned and deferred income reflect the approximate net difference between $2,039,264.43 and $405,706.15 in its 1954 balance sheet.

13. As a result of the adjustments described heretofore, the Commissioner of Internal Revenue on May 15, 1956, asserted an income tax deficiency against plaintiff in the amount of $58,083.58 for the calendar year 1952, and in the amount of $137,907.48 for the calendar year 1953. These deficiencies in tax, plus interest of $2,019.37 for the year 1952 and $10,789.77 for the year 1953, were paid by plaintiff on May 25, 1956, and May 28, 1956.

14. On May 10, 1958, plaintiff filed timely claims for refund for each of the years in suit, which claims for refund raised the issues upon which plaintiff now seeks recovery in this action. On July 1, 1958, the Commissioner of Internal Revenue notified plaintiff by registered letter that its claims for refund had been denied.

15. Plaintiff, a nonstock, membership corporation, obtained substantially all of the funds necessary to carry on the operation of its divisions by dues from its members, paid for one year in advance.

16. Under the method of accounting employed by plaintiff during the years in issue, prepaid dues collected from members of its divisions were not regarded entirely as income for accounting purposes in the calendar year of receipt, but instead prepaid dues were recognized and treated as income ratably over the 12-month membership period whether or not such period extended beyond the close of plaintiff's taxable year.

As of December 31 of each taxable year, the proportion of dues collected within the year which was applicable under plaintiff's system of accounting to memberships extending beyond the close of the taxable year was considered and recorded as a liability of plaintiff and was reflected on plaintiff's balance sheet with its tax return as a liability.

Expenses which plaintiff considered to fall within the category of prepaid membership costs, e.g., salesmen's commissions, and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were not deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that dues were recognized as income.

17. During the calendar years 1953 and 1954, plaintiff recorded on its books and records, by months, the following amounts of prepaid dues collected from members of its divisions:

	1953	1954
January	$257,098.02	$290,764.23
February	236,610.67	284,319.95
March	282,459.08	351,697.47
April	298,647.02	329,088.99
May	328,191.75	382,395.28
June	378,716.30	451,269.61
July	386,150.87	435,832.98
August	336,269.68	395,009.70
September	275,235.54	280,959.54
October	269,681.48	309,543.51
November	219,278.02	279,144.64
December	263,289.26	308,553.22
	3,331,178.67	4,078,529.17

This money was deposited in plaintiff's bank accounts with no restrictions as to its use for any of its corporate purposes.

Section 4 of the bylaws of the American Automobile Association specifically provided for the use of funds and reads as follows:

> SECTION 4. (*Use of Funds*) This corporation shall use its funds only to accomplish the objects and purposes specified in Section 3, and no part of said funds shall inure, or be distributed, to the members of this corporation. On dissolution the funds of the corporation shall be distributed to one or more regularly organized charitable organizations to be selected by the Board of Directors.

18. Under the accounting system employed by the plaintiff from 1931 through 1953 prepaid dues collected from members who joined in the month of January were recognized as income in January to the extent of 1/24 of such collections, on the assumption that the average or mean date would be

the middle of the month. Thereafter, 1/12 of prepaid collections for January was transferred or allocated to income for each of the following 11 months, and 1/24 of January collections remained a liability on December 31 and was transferred and recognized as income for January of the following year.

Prepaid dues for each month of the calendar year were treated in the same manner, that is, 1/24 of such collections was transferred and recognized as income in the current month when collections were made, 1/12 of such collections during the following 11 months and 1/24 thereof in the last month when membership expired. The monthly collections of prepaid dues during a calendar year which were recognized and transferred to income during the current year and the portion thereof remaining in the liability account at the end of the year, which was entitled DEFERRED REVENUE MEMBERSHIP DUES, UNEARNED AND DEFERRED INCOME or some similar title, appear in the following tabulation:

	Portion Treated as Income for the Current Year	*Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year*
January	23/24	1/24
February	21/24	3/24
March	19/24	5/24
April	17/24	7/24
May	15/24	9/24
June	13/24	11/24
July	11/24	13/24
August	9/24	15/24
September	7/24	17/24
October	5/24	19/24
November	3/24	21/24
December	1/24	23/24

The allocation of prepaid dues each month facilitated the preparation of monthly statements of income and expenses. Had monthly collections been equal for each month during a year, the amount recognized as income during the current year and the amount remaining as a liability at the end of the year would have been equal under the foregoing apportionments.

19. Under the method of accounting employed by plaintiff, the proportion existing between dues collected from members of its divisions within a calendar year, which dues

were recognized as income during such year, and the proportion of such dues regarded as a liability at the end of such year was as follows for the calendar years 1949 through 1954:

	Portion Recognized as Income During the Year Collected	Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year
1949	49.9%	50.1%
1950	50.0%	50.0%
1951	50.2%	49.8%
1952	50.6%	49.4%
1953	50.3%	49.7%
1954	50.0%	50.0%

20. Commencing in 1954, in order to simplify much internal detail, the plaintiff changed its procedure in the monthly accounting for prepaid dues by the assignment of 50 percent to income for the current year and 50 percent as a liability which matured as income for the following year.

Plaintiff also adjusted certain inconsistencies in its prepaid expense account in 1954. Some division managers were paid a straight salary, whereas others were paid a nominal salary plus incentive commissions based upon the number of members within the division. These incentive commissions had been previously charged to the prepaid expense account and prorated over membership periods, whereas such incentive pay was actually a part of the manager's compensation. It was treated as current expense in 1954 and thereafter. Also, guaranteed commissions to new salesmen for a certain limited period had been included with commissions earned on subscriptions obtained, as prepaid expense, and beginning in 1954 such unearned guaranteed payments were charged to current expenses.

The plaintiff continued the apportionment of prepaid dues collected and prepaid expenses for commissions and insurance over the period of membership as it had done previously. The basic method of accounting employed by plaintiff in 1954 was consistent with that employed by plaintiff in 1953 and prior years.

21. The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,337,813.44, representing $1,562,042.23 of prepaid dues collected in 1952 but not recog-

nized as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,407.46 of advance dues collected in 1953 but not recognized as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year.

22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices and was, prior to the adverse determination by the Commissioner of the Internal Revenue, customarily and generally employed in the motor club field.[1]

The Internal Revenue Service did not question the method of accounting employed by plaintiff in computing its net income until the calendar year 1954, at which time deficiencies were proposed for the calendar years 1950, 1951 and 1952, but plaintiff was not required to pay those deficiencies by reason of a compromise settlement.

23. The determination of additional income by the Commissioner of the Internal Revenue Service for the taxable years involved herein was made by including as income the advance payment of dues covering membership benefit periods in the following year and excluding those payments received in the prior year that covered membership benefit periods in the current year.

By taking into income for the current year the amount which plaintiff treated as a liability for servicing membership periods in the following year, the amount of such receipts would be reflected in the plaintiff's surplus account at the end of the current year. The plaintiff's balance sheet as of December 31, 1953, filed with its tax returns for 1953

[1] Defendant offered no testimony. Plaintiff's testimony consisted of that of its staff auditors supplemented by outstanding certified public accountants testifying as experts who were, also, either familiar with plaintiff's problem or had some direct association with it and whose qualifications were not challenged. They were: *Dr. Wm. A. Paton*, for 44 years a professor of accounting and economics at the University of Michigan and an author and consultant on accounting. *George E. Baker*, Washington, D.C., resident partner of Ernst and Ernst, Certified Public Accountants. *Herbert T. McAuley*, a general and managing partner of Ernst and Ernst. *E. Alexander Bell*, partner in Peat, Marwick, Mitchell & Co., largest firm of Certified Public Accountants in the world.

and 1954 reflecting the items involved, is compared with the balance sheet which would result from the adjustments by the Commissioner of the Internal Revenue Service in the following table:

	Balance Sheet on December 31, 1953	
	(a) Reported by the Plaintiff	(b) Reflecting the Adjustments by the Commissioner of IRS
ASSETS:		
Cash	$1,941,723.88	$1,941,723.88
Prepaid membership cost	398,482.36	----------
Prepaid commissions	177,079.51	177,079.51
All other accounts, net	2,834,525.72	2,834,525.72
Total assets	5,351,811.47	4,953,329.11
LIABILITIES:		
Unearned and deferred income	1,756,485.46	----------
All other liabilities	1,063,462.99	1,063,462.99
Total liabilities	2,819,948.45	1,063,462.99
SURPLUS	2,531,863.02	3,889,866.12

24. The defendant contends that the sole issue is whether the Commissioner of Internal Revenue erred in refusing to allow plaintiff to defer a portion of income actually received, without any restriction as to its use, from the year in which it was received to the following year when services might have to be performed under the membership contracts.

The plaintiff's gross income from dues was measured by collections for the period memberships were in effect during the current year. This included pro rata amounts of prepaid dues collected in the prior year covering membership periods that extended into the current year, but excluded prepaid dues collected in the current year for membership periods that extended into the following year. The membership service costs and other operating expenses paid or incurred during the current year were then deducted from such gross income for its determination of net income.

25. Restrictions on the use of funds represented by prepaid dues were not required or intended by the plaintiff's members. On the contrary, the receipt of prepaid dues from members constituted the principal source of plaintiff's operating funds as heretofore found. Funds from other sources,

such as sales of publications, materials and supplies, advertising, etc., were normally received only after the costs and expenses were incurred in producing such revenues.

There is no evidence that membership contracts, or certificates issued by plaintiff to its members, provided any restriction in the use of funds received by plaintiff for dues paid in advance. Plaintiff's financial responsibility is not questioned.

26. The plaintiff prepared and submitted tabulations of the aggregate costs incurred by all of its divisions in servicing all members thereof for each month of each year from 1948 through 1954. These tabulations were received as plaintiff's exhibits 2 through 7, inclusive.

Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed.

27. The proportions of prepaid dues transferred and assigned to gross income by the plaintiff on a pro rata monthly time basis are compared with the proportion of assignments under the average monthly cost bases for servicing memberships in the following table:

	Plaintiff's Pro Rata Method as Reported	*Average Monthly Costs for Current Year*	*Average Monthly Costs Over Prior 5-Year Period*
1953			
Apportioned to Gross Income during current year	50.3%	49.8%	50.4%
Deferred to the Following Year (reported as a liability at the end of the current year)	49.7%	50.2%	49.6%
1954			
Apportioned to Gross Income during the current year	50.0%	48.8%	51.0%
Deferred to the following year (reported as a liability at the end of the current year)	50.0%	51.2%	49.0%

In the United States Court of Claims

No. 311-58

(Filed JUL 16 1959)

AMERICAN AUTOMOBILE ASSOCIATION v. THE UNITED STATES

REPORT OF COMMISSIONER

To the Honorable the CHIEF JUDGE AND ASSOCIATE JUDGES OF THE UNITED STATES COURT OF CLAIMS:

Pursuant to the order of reference in the above-entitled case, the undersigned Commissioner makes the following report of his findings of fact:

1. Plaintiff is a corporation with its principal office at 1712 G Street, Northwest, Washington, D.C. Plaintiff was incorporated in the year 1910 under the laws of the State of Connecticut and was organized and is operated as a non-stock, membership corporation.

2. Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel.

3. In addition to the activities described in paragraph two above, plaintiff operates directly, as divisions, the following local automobile clubs:

District of Columbia Division of AAA
(Metropolitan area, Washington, D. C.)
Louisiana Division of AAA (entire state)
Massachusetts Division of AAA (part of state)
New Hampshire Division of AAA (entire state)
New Mexico Division of AAA (entire state)
North Florida Division of AAA
South Florida Division of AAA } (part of state)
Texas Division of AAA (part of state)
Wisconsin Division of AAA (entire state)
Wyoming Division of AAA (entire state)

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4. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs described in paragraph three and operated as divisions of plaintiff. Plaintiff is obligated to provide services for such members over the 12-month period following payment of dues. The services provided by plaintiff for the members of its divisions during the years in issue, although tending to be parallel, were not completely uniform and included the following: (a) A complete travel service which included trip planning, tour books, accommodation directories, maps and recommended routes. (b) Emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs. The road service was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions. (c) Bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen. (d) Personal automobile accident insurance which included hospitalization, personal injury and death benefits on a sliding scale in the event of a motoring accident. The plaintiff contracted for the insurance on a group basis and paid the premiums on the group policies. (e) A theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car. In addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

5. In order to make available and provide for the members of its divisions the services which plaintiff contracted to provide, plaintiff during the years in issue owned or rented offices in 39 to 41 different geographical locations and had on its divisions' payroll 495 employees in December 1953 and 603 employees in December 1954.

6. Plaintiff, commencing with the calendar year 1943, has been required to file Federal income tax returns and to pay Federal income taxes on its net income. Its Federal income tax returns are filed with the District Director of Internal Revenue, Baltimore, Maryland. The plaintiff's taxable year is the calendar year.

7. Plaintiff employs the accrual method of accounting in keeping its books and records and in filing its Federal income tax returns.

8. Plaintiff, within the time prescribed by law, filed Federal income tax returns with the District Director of Internal Revenue, Baltimore, Maryland, for the calendar years 1952, 1953 and 1954. The 1952 return reported a net income of $152,975.51, the 1953 return reported a net income of $352,125.84, and the 1954 return reported a net operating loss in the amount of $290,186.04.

9. Upon audit of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue made several minor adjustments which are not in issue in this proceeding, the net effect of which was to increase plaintiff's 1952 net income to $154,411.11, to increase plaintiff's 1953 net income to $353,279.09, and to reduce plaintiff's 1954 net operating loss to $289,967.67.

10. Plaintiff claimed that as a result of its 1954 net operating loss in the amount of $289,967.67, it was entitled to a net operating loss carryback deduction to 1952 in the amount of $154,411.11, and a net operating loss carryback deduction to 1953 in the amount of $135,556.56.

11. Upon audit of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue also determined not to recognize the method of accounting employed by plaintiff in computing its income derived from prepaid dues collected from members of its divisions during the calendar years 1953 and 1954, which is the issue in this proceeding. The net effect of such determination was to increase plaintiff's 1953 net income from $353,279.09 to $481,557.59 and to reduce plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49, with the further result that the Commissioner reduced plaintiff's net operating loss carryback deduction from $154,411.11 in 1954 to $14,412.49 in 1952 and eliminated entirely any net operating loss carryback deduction from 1954 to 1953.

12. The Commissioner of Internal Revenue determined the increase of plaintiff's income for 1953 by $128,278.50 and

the reduction of plaintiff's loss for 1954 by $275,555.15 was in the following manner:

	1953 Adjustments	1954 Adjustments
Reserve for unearned and deferred income Dec. 31 of current year	$1,736,485.46	$2,039,264.43
Less reserve for unearned and deferred income Dec. 31 of prior year	1,562,042.23	1,736,485.46
Difference	194,443.23	282,778.97
Less		
Prepaid commissions:		
Dec. 31 of current year	398,482.36	405,706.15
Dec. 31 of prior year	332,317.63	398,482.36
Difference	66,164.73	7,223.79
Net additional income determined for the current year	128,278.50	275,555.18

All of the foregoing items are reflected in the plaintiff's balance sheets as of December 31 for the years involved, which were filed with its income tax returns for 1953 and 1954. The liabilities contain the account UNEARNED AND DEFERRED INCOME, and the assets contain the account PREPAID COMMISSIONS, but the latter account is not involved in the items labeled prepaid commissions in the above tabulation. The deduction items employed by the Commissioner of the Internal Revenue Service represent plaintiff's asset account for prepaid membership costs. The plaintiff's assets for 1954 do not reflect any amount for prepaid membership costs, but its liabilities for unearned and deferred income reflect the approximate net difference between $2,039,264.43 and $405,706.15 in its 1954 balance sheet.

12. As a result of the adjustments described heretofore, the Commissioner of Internal Revenue on May 15, 1956, asserted an income tax deficiency against plaintiff in the amount of $56,083.58 for the calendar year 1952, and in the amount of $137,907.48 for the calendar year 1953. These deficiencies in tax, plus interest of $2,019.37 for the year 1952 and $10,789.77 for the year 1953, were paid by plaintiff on May 25, 1956, and May 28, 1956.

14. On May 10, 1958, plaintiff filed timely claims for refund for each of the years in suit, which claims for refund raised the issues upon which plaintiff now seeks recovery in this action. On July 1, 1958, the Commissioner of Internal Revenue notified plaintiff by registered letter that its claims for refund had been denied.

15. Plaintiff, being a nonstock, membership corporation, obtained substantially all of the funds necessary to carry on the operation of its divisions by advances from its members, i.e., dues prepaid for one year in advance in consideration of services to be rendered by plaintiff over the ensuing 12-month period.

Plaintiff's balance sheets filed with its 1953 and 1954 income tax returns reflect cash on hand December 31, 1953, of $1,941,723.88 and dues paid in advance of $1,756,485.46. The excess of $185,238.42 would represent cash received from other sources. However, on December 31, 1954, the dues collected in advance and reported in plaintiff's balance sheet at $1,634,840.81 exceeded the cash on hand of $1,502,478.97 by the sum of $132,361.84.

16. Under the method of accounting employed by plaintiff during the years in issue, advance dues collected from members of its divisions were not regarded entirely as income for accounting purposes in the calendar year of receipt, but instead advance dues were recognized and treated as income ratably over the 12-month period during which plaintiff was obligated to render services to such members whether or not such period extended beyond the close of plaintiff's taxable year.

As of December 31 of each taxable year, the proportion of advance dues, collected within the year applicable to membership contracts extending beyond the close of the taxable year and for which services had not yet been rendered or made available, was considered and recorded as a liability of plaintiff and was reflected on plaintiff's balance sheet with its tax return as a liability.

Expenses which plaintiff considered to fall within the category of prepaid membership costs, i.e., salesmen's commissions, and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were not

deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that advance dues were recognized as income.

17. During the calendar years 1953 and 1954, plaintiff recorded on its books and records, by months, the following amounts of prepaid or advance dues collected from members of its divisons:

	1953	1954
January	$237,698.02	$290,764.23
February	236,610.67	284,319.95
March	282,430.08	351,697.47
April	286,647.62	329,691.90
May	328,191.75	382,385.38
June	378,736.30	451,200.81
July	386,150.87	435,852.93
August	336,202.01	395,009.70
September	275,235.54	290,150.34
October	268,031.48	309,543.51
November	219,278.02	279,144.44
December	265,289.26	308,753.22
	3,531,178.07	4,095,529.17

This money was deposited in plaintiff's bank accounts with no restrictions as to its use for any of its corporate purposes. It was, in fact, prepaid financing by the members for the corporation's operating funds, including the cost of services to be performed during the following 12-month period of membership, as reported in finding 15 herein.

Section 4 of the bylaws of the American Automobile Association specifically provided for the use of funds and reads as follows:

> SECTION 4. (*Use of Funds*) This corporation shall use its funds only to accomplish the objects and purposes specified in Section 3, and no part of said funds shall inure, or be distributed, to the members of this corporation. On dissolution the funds of the corporation shall be distributed to one or more regularly organized charitable organizations to be selected by the Board of Directors.

18. Prepaid dues were true liabilities of the plaintiff at the time they were collected. Under the accounting system employed by the plaintiff from 1931 through 1953 advance dues collected from members who joined in the month of

January were recognized as income in January to the extent of 1/24 of such collections, on the assumption that the average or mean date would be the middle of the month. Thereafter, 1/12 of prepaid collections for January was transferred or allocated to income for each of the following 11 months, and 1/24 of January collections remained a liability on December 31 and was transferred and recognized as income for January of the following year.

Prepaid dues for each month of the calendar year were treated in the same manner, that is, 1/24 of such collections was transferred and recognized as income in the current month when collections were made, 1/12 of such collections during the following 11 months and 1/24 thereof in the last month when membership expired. The monthly collections of prepaid dues during a calendar year which were recognized and transferred to income during the current year and the portion thereof remaining in the liability account at the end of the year, which was entitled DEFERRED REVENUE MEMBERSHIP DUES, UNEARNED AND DEFERRED INCOME or some similar title, appear in the following tabulation:

	Portion Treated as Income for the Current Year	*Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year*
January	23/24	1/24
February	21/24	3/24
March	19/24	5/24
April	17/24	7/24
May	15/24	9/24
June	13/24	11/24
July	11/24	13/24
August	9/24	15/24
September	7/24	17/24
October	5/24	19/24
November	3/24	21/24
December	1/24	23/24

The allocation of prepaid dues each month facilitated the preparation of monthly statements of income and expenses. Had monthly collections been equal for each month during a year, the amount recognized as income during the current year and the amount remaining as a liability at the end of the year would have been equal under the foregoing apportionments.

19. Under the method of accounting employed by plaintiff, the proportion existing between dues collected from members of its divisions within a calendar year, which dues were recognized as income during such year, and the proportion of such dues regarded as a liability at the end of such year was as follows for the calendar years 1949 through 1954:

	Portion Recognized as Income During the Year Collected	Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year
1949	49.9%	50.1%
1950	50.0%	50.0%
1951	50.2%	49.8%
1952	50.6%	49.4%
1953	50.3%	49.7%
1954	50.0%	50.0%

20. Commencing in 1954, in order to simplify much internal detail, the plaintiff changed its procedure in the monthly accounting for prepaid dues by the assignment of 50 percent to income for the current year and 50 percent as a liability which matured as income for the following year.

Plaintiff also adjusted certain inconsistencies in its prepaid expense account in 1954. Some division managers were paid a straight salary, whereas others were paid a nominal salary plus incentive commissions based upon the number of members within the division. These incentive commissions had been previously charged to the prepaid expense account and prorated over membership periods, whereas such incentive pay was actually a part of the manager's compensation. It was treated as current expense in 1954 and thereafter. Also, guaranteed commissions to new salesmen for a certain limited period had been included with commissions earned on subscriptions obtained, as prepaid expense, and beginning in 1954 such unearned guaranteed payments were charged to current expenses.

The plaintiff continued the apportionment of prepaid dues collected and prepaid expenses for commissions and insurance over the period of membership as it had done previously. The basic method of accounting employed by plaintiff in 1954 was consistent with that employed by plaintiff in 1953 and prior years.

21. The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,337,813.44, representing $1,562,042.23 of prepaid dues collected in 1952 but not recognized as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,407.46 of advance dues collected in 1953, but not recognized as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year.

22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and was used both before and after plaintiff was required to pay Federal income taxes. The method of accounting employed by plaintiff during the years in issue is in accord with generally accepted accounting principles and practices and is customarily and generally employed in the motor club field.

The Internal Revenue Service did not question the method of accounting employed by plaintiff in computing its net income until the calendar year 1954, at which time deficiencies were proposed for the calendar years 1950, 1951 and 1952, but plaintiff was not required to pay those deficiencies by reason of a compromise settlement.

23. Under generally accepted accounting principles a distinction is made between a financing transaction and a revenue or income transaction. Funds received in a revenue or income transaction are reflected in the profit and loss statement of a taxpayer as gross income. This is not true in the case of funds received in a financing transaction. They are reflected in the balance sheet as liabilities.

Financing transactions involve ways and means of raising funds for business operations and may be grouped under three general types: (a) funds obtained from shareholders in exchange for stock; (b) funds obtained from banks or other lenders on notes, bonds or other evidence of indebtedness; and (c) funds obtained by advances from customers or members on open accounts, receipts or certificates of

membership for future delivery of goods or services to be rendered in the future.

Funds representing advances from customers or members of an organization are not income at the time they are received but constitute a liability until such time as goods are delivered or services are rendered or made available in accordance with the advance payment agreement. It is an undisputed principle of accounting that no revenue or income can emerge until goods are delivered or until services are rendered.

Upon the prepayment of annual dues a member of the plaintiff corporation acquired a right to receive certain materials, information and services provided in the membership agreement over a 12-month period. Plaintiff's liability to such member cannot be completely discharged until the expiration of the membership period. Under generally accepted accounting principles, it is realistic and reasonable to recognize and transfer to gross income such prepaid dues ratably over the period of membership.

24. The determination of additional income by the Commissioner of the Internal Revenue Service for the taxable years involved herein was made by including as income the advance payment of dues covering membership benefit periods in the following year and excluding those payments received in the prior year that covered membership benefit periods in the current year. This application of the receipt of funds as income is contrary to generally accepted accounting principles and practices.

By taking into income for the current year the plaintiff's liability for servicing membership periods in the following year, the amount of such receipts would be reflected in the plaintiff's surplus account at the end of the current year. The plaintiff's balance sheet as of December 31, 1953, filed with its tax returns for 1953 and 1954 reflecting the items involved, is compared with the balance sheet which would result from the adjustments by the Commissioner of the Internal Revenue Service in the following table:

	Balance Sheet on December 31, 1953	
	(a) Reported by the Plaintiff	(b) Reflecting the Adjustments by the Commissioner of IRS
ASSETS:		
Cash	$1,941,723.88	$1,941,723.88
Prepaid membership cost	308,482.36	
Prepaid commissions	177,079.51	177,079.51
All other accounts, net	2,834,525.72	2,834,525.72
Total assets	5,351,811.47	4,953,329.11
LIABILITIES:		
Unearned and deferred income	1,756,485.46	
All other liabilities	1,063,462.99	1,063,462.99
Total liabilities	2,819,948.45	1,063,462.99
SURPLUS	2,531,863.02	3,889,866.12

The above statement (b), embodying the adjustments by the Commissioner of the Internal Revenue Service, reflects an overstatement of surplus for 1953 of $1,358,003.10, or approximately 54 percent in excess of the true surplus.

By applying similar adjustments to plaintiff's balance sheet as of December 31, 1954, the surplus would be increased and overstated by $1,634,840.81, or approximately 99 percent, and would omit plaintiff's liability to members for a similar amount.

A balance sheet as of any given date represents an inventory of cash and accounting evaluations of all other asset accounts and liability accounts of an individual or firm on the date designated, and is prepared for the purpose of reflecting the net worth and financial responsibility of such firm or individual.

The evidence establishes that reputable members of the accounting profession would not certify to the accuracy of the income statements and the balance sheets reflecting the adjustments by the Commissioner of the Internal Revenue Service.[1]

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[1] Defendant offered no testimony. Plaintiff's testimony consisted of that of its staff auditors supplemented by outstanding certified public accountants testifying as experts who were, also, either familiar with plaintiff's problem or had some direct association with it and whose qualifications were not challenged. They were: *Dr. Wm. A. Paton*, for 44 years a professor of accounting and economics at the University of Michigan and an author and consultant on accounting. *George E. Baker*, Washington, D.C., resident partner of Ernst and Ernst, Certified Public Accountants. *Herbert F. McAuley*, a general and

25. The defendant contends that the sole issue is whether the Commissioner of Internal Revenue erred in refusing to allow plaintiff to defer a portion of income actually received, without any restriction as to its use, from the year in which it was received to the following year when services might have to be performed under the membership contracts.

The advance payment on a service contract, or any other type of contract, does not constitute income or revenue to the recipient, although the acceptance thereof creates a liability to perform. Under generally accepted accounting principles, the accounting for the funds received in advance must be recorded as a liability of the recipient. The plaintiff did this consistently since 1931. These membership contracts entitled the members to receive membership services over a period of 12 months from the date of subscription and acceptance. The plaintiff's gross income from dues was measured by collections for the period memberships were in effect during the current year. This included pro rata amounts of prepaid dues collected in the prior year covering membership periods that extended into the current year, but excluded prepaid dues collected in the current year for membership periods that extended into the following year. The membership service costs and other operating expenses paid or incurred during the current year were then deducted from such gross income for its determination of net income.

The method of accounting employed by plaintiff was in accordance with accepted accounting principles. The assignment and transfer of funds from the prepaid dues account to revenue or gross income measured over the period of the membership contracts is found to be the most realistic method for properly recording gross income from dues.

26. The restriction of funds represented by prepaid dues was not required or intended by the plaintiff's members. On the contrary, the receipt of prepaid dues from members constituted the principal source of plaintiff's operating funds as heretofore found. Funds from other sources, such as sales of publications, materials and supplies, advertising, etc., were normally received only after the costs and expenses were incurred in producing such revenues.

Managing partner of Ernst and Ernst. *H. Alexander Bell*, partner in Prot. Marwick, Mitchell & Co., largest firm of Certified Public Accountants in the world.

There is no evidence that membership contracts, or certificates issued by plaintiff to its members, provided any restriction in the use of funds received by plaintiff for dues paid in advance. Plaintiff's financial responsibility is not questioned.

27. The plaintiff prepared and submitted tabulations of the aggregate costs incurred by all of its divisions in servicing all members thereof for each month of each year from 1948 through 1954. These tabulations were received as plaintiff's exhibits 2 through 7, inclusive.

Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed.

28. The proportions of prepaid dues transferred and assigned to gross income by the plaintiff on a pro rata monthly time basis are compared with the proportion of assignments under the average monthly cost bases for servicing memberships in the following table:

	Plaintiff's Pro Rata Method as Reported	Average Monthly Costs for Current Year	Average Monthly Costs Over Prior 1-Year Period
1953			
Apportioned to Gross Income during current year	50.3%	49.8%	50.4%
Deferred to the Following Year (reported as a liability at the end of the current year)	49.7%	50.2%	49.6%
1954			
Apportioned to Gross Income during the current year	50.0%	48.8%	51.0%
Deferred to the following year (reported as a liability at the end of the current year)	50.0%	51.2%	49.0%

29. The recognition, assignment and transfer of dues collected in advance to gross income on the basis of actual costs of servicing members is feasible under the accrual method

of accounting, particularly in testing the results of prorating such collections on a time basis. It is not as practicable as the assignment of prepaid dues on a pro rata monthly basis because the current costs incurred must first be determined. The employment of a prior year's monthly costs or a composite of monthly costs for five prior years might not be as accurate as the method actually employed by plaintiff because of a constant increase in membership reflected over the years or by abnormal costs of servicing members during one or more of such prior years.

When members paid their annual membership dues they became entitled to membership services over a period of 12 months, notwithstanding any variations in costs to the plaintiff in furnishing the services that might be required. When plaintiff accepted such dues it became obligated to perform the services to which members were entitled and might require over the membership period without regard to any variations or fluctuations in costs in furnishing such services from month to month over the membership period.

On the evidence presented, the recognition and assignment of prepaid dues ratably over the period of membership is found to be the most realistic and practical method of accounting for gross income from membership dues.

30. The plaintiff's membership for all divisions reflects a constant increase from month to month during 1953 and 1954. The minimum number of memberships in effect in 1953 was 229,435 in January and the maximum was 246,856 in December of that year. The minimum number of memberships in effect in 1954 was 249,805 in January and the maximum was 295,889 in December of that year. The average cost to plaintiff of servicing a member during the calendar year 1953 was $14.50 and the average cost for 1954 was $14.72.

31. The plaintiff's liability for servicing members whose membership continued beyond the current year when dues were paid was not a "contingent" liability. It was a true liability and the costs were substantially in proportion to membership from year to year with reasonable constancy from month to month. The plaintiff's actual costs of serv-

ing all members from 1948 to 1954 are set out in the following tabulation:

1948	$1,587,794.87
1949	1,698,144.27
1950	2,012,406.23
1951	2,614,386.96
1952	3,109,098.21
1953	3,377,389.91
1954	3,991,068.00

32. The actual average monthly cost per membership in effect during 1953 and 1954 and the percentage of the total annual cost per member is reported in the following tabulation, with the percentage of the total monthly costs to the total costs for the preceding five-year period:

Month	1953			1954		
	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period
	Amount	Percent of cost for year		Amount	Percent of cost for year	
ary	$1 12	7 71	7 48	$1 12	7 62	7 46
ruary	1 10	7 57	7 47	1 27	8 62	7 34
ch	1 24	8 52	8 54	1 35	9 27	8 44
il	1 32	9 15	8 84	1 24	8 41	8 82
y	1 28	8 84	8 97	1 35	9 18	8 83
e	1 32	9 12	9 04	1 41	9 56	9 07
y	1 35	9 29	8 90	1 34	9 12	8 93
ust	1 23	8 72	8 58	1 24	8 41	8 67
tember	1 19	8 25	8 15	1 20	8 16	8 26
ober	1 19	8 19	8 20	1 17	7 93	8 42
ember	1 06	7 29	7 56	1 10	7 39	7 65
ember	1 10	7 59	8 29	91	6 21	8 11
Total	14 50	100 00	100 00	14 72	100 00	100 00

The foregoing tabulation reflects the actual average cost to plaintiff in each month of the years involved for each member whose membership continued in effect. The difference between the costs incurred for servicing memberships that continued from the prior year and the membership fees collected in the prior year, but remaining as a liability of the plaintiff at the end of the year and transferred to gross income in the current year, would represent the net income in the current year applicable to such memberships.

33. The plaintiff's liability to members for that portion of their memberships which extended beyond the current year

in which plaintiff collected the dues in advance is not gross income from membership dues because it was paid and received for a later year. Neither can it be net income in the year when the dues were received because the cost of servicing such memberships could not be performed until the following year when such net income would be realized.

The method of accounting employed by the plaintiff during the calendar years 1953 and 1954 and prior years in keeping its books and records clearly reflected its net income for such years. The plaintiff's income tax returns for 1953 and 1954 were prepared in accordance with the method of accounting employed in keeping its books and records and clearly reflected the net income for these years. This conclusion and the findings set forth above are supported by the overwhelming weight of the documentary evidence and expert testimony.

Respectfully submitted.

MARION T. BENNETT, *Commissioner.*

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No. 288

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In the Supreme Court of the United States

OCTOBER TERM, 1960

AMERICAN AUTOMOBILE ASSOCIATION, PETITIONER

v.

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Claims

---

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

J. LEE RANKIN,
Solicitor General,
Department of Justice,
Washington 25, D. C.

In the Supreme Court of the United States

OCTOBER TERM, 1960

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AMERICAN AUTOMOBILE ASSOCIATION, PETITIONER

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On Petition for a Writ of Certiorari to the United States Court of Claims

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MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

This case presents the same question as *New Jersey Automobile Club* v. *United States*, pending on petition for a writ of certiorari (No. 140). Both cases were decided by the Court of Claims the same day. For the reasons stated in the brief in opposition filed in No. 140, the petition here should also be denied.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

AUGUST 1960

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IN THE

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OCTOBER TERM, 1960

No. 288

AMERICAN AUTOMOBILE ASSOCIATION, *Petitioner*

v.

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Claims

---

REPLY TO MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The Solicitor General, in opposing certiorari in the case at bar, blandly assumes that this case presents the same question as *New Jersey Automobile Club* v. *United States,* also pending on petition for a writ of certiorari (No. 140).

Such is not the case, the difference being that petitioner *here* has proved by uncontradicted evidence,

including expert testimony, that its regularly employed method of accounting for prepaid membership dues was "realistic," was in accord with sound accounting principles, and did reflect its income clearly. By contrast, the Court of Claims, in *New Jersey Automobile Club, supra,* found as a fact that the method of accounting used by that taxpayer did not clearly reflect its income.

In its Brief in Opposition to Certiorari in the *New Jersey Automobile Club* case, the Solicitor General argued:

> "In an effort to avoid the controlling effect of the decision in *Automobile Club of Michigan,* the taxpayer fails to address itself to the critical question—dispositive of this case and decided adversely to it below—of whether its method of accounting clearly reflected its taxable income."

Such a contention has no conceivable application to the case at bar, where the findings of fact made by the Court of Claims, including Nos. 22, 23, 26, 27, 28, 30 and 31, clearly establish that the petitioner did prove that its method of accounting was in accord with generally accepted accounting principles and practices and clearly reflected its income.

Petitioner based its request for a writ of certiorari on the ground that a direct conflict exists between the decision of the Court of Claims in the case at bar and the decision of the United States Court of Appeals for the Second Circuit in *Bressner Radio, Inc.* v. *Commissioner,* 267 F. (2d) 520 (1959). Petitioner also relied upon the diametrically opposed interpretations of this Court's decision in *Automobile Club of Michigan, supra.*

The United States, in its Memorandum in Opposition to Certiorari in *New Jersey Automobile Club,* fails to mention or discuss either point. Petitioner respectfully suggests that the Solicitor General file a supplemental brief in the case at bar which addresses itself not to the issue involved in another case but to the issue involved in this proceeding, namely, whether the decision of this Court in *Automobile Club of Michigan* v. *Commissioner, supra,* was intended to deny to a taxpayer the use of a method of accounting for prepaid membership dues which does clearly reflect its income.

Respectfully submitted,

FLEMING BOMAR
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No. 288

In the Supreme Court of the United States

OCTOBER TERM, 1960

AMERICAN AUTOMOBILE ASSOCIATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

SUPPLEMENTAL MEMORANDUM FOR THE UNITED STATES

J. LEE RANKIN,
Solicitor General,
Department of Justice,
Washington 25, D.C.

In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 288

AMERICAN AUTOMOBILE ASSOCIATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

SUPPLEMENTAL MEMORANDUM FOR THE UNITED STATES

In its reply to the memorandum for the United States in opposition, petitioner denies that this case presents the same question as *New Jersey Automobile Club* v. *United States,* also pending on petition for certiorari (No. 140); and it asserts that, in contrast to the *New Jersey* case where the Court of Claims found that the method of accounting used by that taxpayer did not clearly reflect its income, here the taxpayer's method of accounting was "realistic", "in accord with generally accepted accounting principles * * * and clearly reflected its net income". (Reply, p. 2.)

We point out, however, that the Court of Claims treated both this case and the *New Jersey* case as presenting essentially the same contentions as were re-

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jected by this Court in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180. Thus, in its opinion in *New Jersey Automobile Club* v. *United States*, the court stated (181 F. Supp. 250, 262–263):

> In *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 77 S. Ct. 707, 1 L.Ed. 2d 746, rehearing denied, 1957, 353 U.S. 989, 77 S. Ct. 1279, 1 L.Ed. 2d 1147, the Supreme Court dealt with the same method of treatment of prepaid automobile club membership dues used by the plaintiff in the case at bar. For the reasons stated in *American Automobile Association* v. *United States*, Ct. Cl., 181 F. Supp. 255, we hold that the Court's decision in *Automobile Club of Michigan* precludes us from overruling the Commissioner's determination that the plaintiff's method of accounting does not clearly reflect income.

In its opinion in the instant case the Court of Claims stated (pp. 5–6):

> * * * we agree with the Government's contention that the method of treatment of prepaid automobile club membership dues employed by the plaintiff was dealt with by the Supreme Court in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, rehearing denied, 353 U.S. 989 (1957), and was held to be, at least for Federal income tax purposes, "purely artificial." * * *
>
> The Commissioner of Internal Revenue had determined that this method of accounting—which is essentially the same method used by the plaintiff in the case at bar—did not clearly reflect income. * * * Although it would ap-

pear that *Automobile Club of Michigan* does not expressly rule out deferral of income, we are constrained to interpret this language [in the Court's opinion] as a rejection by the Supreme Court of the accounting method advanced by plaintiff in the case at bar.

Respectfully submitted.

J. LEE RANKIN,
Solicitor General.

SEPTEMBER 1960.

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OCTOBER TERM, 1960

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AMERICAN AUTOMOBILE ASSOCIATION, *Petitioner*,

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UNITED STATES

BRIEF FOR PETITIONER

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IN THE

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OCTOBER TERM, 1960

No. 288

AMERICAN AUTOMOBILE ASSOCIATION, *Petitioner,*

v.

UNITED STATES

BRIEF FOR PETITIONER

OPINION BELOW

The Findings of Fact and the Opinion of the Court of Claims are reported in — Ct. Cls. — [R. 51-71]; the opinion of the Court of Claims is reported in 181 F. Supp. 255.

JURISDICTION

The Court of Claims entered its judgment dismissing petitioner's suit on March 2, 1960. Petitioner filed a timely motion for rehearing and for amendment of findings of fact and conclusions of law on March 25, 1960. The Court of Claims entered an order denying

such motion on May 4, 1960. A petition for writ of certiorari was filed by petitioner August 2, 1960 and granted October 10, 1960. Jurisdiction of this Court to review the decision below rests upon 28 U.S.C. Sec. 1255(1).

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations which the case involves are set forth in the Appendix. They are:

Statutes:

Internal Revenue Code of 1939:

Sec. 41, 53 Stat. 24 (1939).
Sec. 42, 53 Stat. 24 (1939).

Internal Revenue Code of 1954:

Sec. 441.
Sec. 446.
Sec. 451.

Treasury Regulations:

Regulations 118:

Sec. 39.41-1 (1953).
Sec. 39.41-2(a) (1953).
Sec. 39.42-1(a) (1953).

Regulations under the 1954 Code:

Sec. 1.446-1(a) (1957).
Sec. 1.451-1(a) (1957).

QUESTIONS PRESENTED

(1) Where a motor club establishes by uncontradicted evidence, including expert accounting testimony, that its regularly employed method of accounting for prepaid membership dues is "realistic", is in accord

with generally accepted accounting principles and practices and reflects its income clearly, is that motor club to be denied the use of such method of accounting for federal income tax purposes by reason of the decision of this Court in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957)?

(2) Under federal income tax laws, may a motor club which has long employed the accrual method of accounting report annual prepaid membership dues as "income" over the twelve month membership period, instead of entirely in the year of receipt, if its accounting method is in accord with generally accepted accounting principles, results in matching during the same taxable periods the dues received from members with the expenses incurred in serving such members, and clearly reflects the net income of the club?

STATEMENT OF FACTS

This is a federal income tax case. Petitioner, the American Automobile Association, seeks to recover from the United States the sum of $207,994.56 with interest according to law representing deficiencies in federal income taxes and interest improperly collected by the United States for the calendar years 1952 and 1953. [R. 1].

Petitioner is a corporation with principal offices located at 1712 G Street, N. W., Washington, D. C. Petitioner was incorporated in the year 1910 under the laws of the State of Connecticut and was organized and is operated as a nonstock, membership corporation. [R. 1, 7, 58].

Petitioner's activities are divided into two major parts:

(1) Petitioner is a national organization which renders services to affiliated local automobile clubs and their members and which performs services of a public nature in fields relating to motoring and travel. This aspect of petitioner's activities is *not* involved in this proceeding. [R. 1, 7, 58].

(2) Petitioner operates directly as divisions ten local automobile clubs located in various sections of the United States. [R. 1, 2, 7, 58].

Separate books and records are maintained by petitioner with respect to the revenue and expenses of its national operations as contrasted with the revenue and expenses of its ten local automobile clubs. [Supp. R. 22].

Petitioner employs the accrual method of accounting in keeping its books and records and in filing its federal income tax returns. [R. 2, 7, 60].

The taxable year of petitioner is the calendar year. [R. 2, 7].

Substantially all of the funds necessary to carry on the operation of petitioner's divisions are obtained by dues from its members paid for one year in advance. [R. 62].

Petitioner is obligated to provide services for such members over the twelve month period following payment of dues, which services include but are not limited to emergency road service, complete travel information and travel services, bail bond protection, personal automobile accident insurance and similar services. [R. 2, 7, 59].

Although a membership in an automobile club operated as a division of petitioner covers a twelve month period, *a membership is not based on the calendar year.* Instead memberships extend from the month of the year in which the member joins the club to the same month of the following calendar year. [R. 63]. A substantial number of members join each and every month and the number of memberships in effect was constantly increasing during the years in issue. [R. 70].

Under the method of accounting employed by petitioner during the years in issue prepaid dues collected from members of its divisions were not regarded as "income" for accounting purposes entirely in the calendar year of receipt. Instead prepaid dues upon receipt were posted to a liability account labeled "Unearned and Deferred Income." Thereafter, on a time basis as petitioner rendered or made available services to its members, the liability account was debited and petitioner's "income" account was credited so that advance dues were reflected in full as taxable income ratably over the twelve month period that petitioner was obligated to render services to such members—whether or not such period extended beyond the close of petitioner's taxable year. [R. 62, Supp. R. 9, 10]. For example, if a member joined the club on July 1, 1953 and paid annual membership dues of $15.00, petitioner would reflect $7.50 as income in 1953 and the remaining $7.50 as income in 1954.

Prepaid membership costs were accounted for by petitioner in a manner consistent with its treatment of prepaid membership dues. [R. 62].

As of the end of each calendar year prepaid dues collected by petitioner during the year for which no

services could be rendered or costs incurred continued to be reflected on petitioner's books and records in the liability account entitled "Unearned and Deferred Income." Such advance dues were transferred to the "income" account the following year. [R. 61].

Prepaid membership dues collected by petitioner during the years in issue were deposited in petitioner's bank accounts with no express restrictions as to their use for any corporate purposes other than petitioner's contractual obligation to render future services to its members. [R. 63]. As of December 31, 1953 petitioner's liability account for "Unearned and Deferred Income" totaled $1,756,485.46. On such date petitioner's prepaid membership costs equaled $398,482.36. Petitioner had cash on hand in the amount of $1,941,723.88 with which its liabilities could have been satisfied. [R. 13, 14].

As of December 31, 1954 petitioner's liability account labeled "Unearned and Deferred Income" equaled $2,039,264.43. Prepaid expenses equaled $405,706.15. [R. 61]. On such date petitioner had cash on hand in the amount of $1,502,478.97 with which its liabilities could have been satisfied. [R. 13, 14].

The actual costs incurred by petitioner in serving its members during the years in issue were substantially in proportion to membership from year to year with reasonable constancy from month to month. [R. 70-71].

The actual cost incurred by petitioner in serving one member per month during the years in issue was as follows:

Month	1953			1954		
	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period
	Amount	Percent of cost for year		Amount	Percent of cost for year	
January	$1.12	7.71	7.48	$1.12	7.62	7.46
February	1.10	7.57	7.47	1.27	8.62	7.34
March	1.24	8.52	8.54	1.37	9.27	8.44
April	1.32	9.15	8.83	1.24	8.41	8.82
May	1.28	8.84	8.97	1.35	9.18	8.83
June	1.32	9.12	9.03	1.41	9.56	9.07
July	1.35	9.28	8.99	1.34	9.12	8.93
August	1.23	8.52	8.58	1.24	8.41	8.67
September	1.19	8.22	8.15	1.20	8.16	8.26
October	1.19	8.19	8.20	1.17	7.95	8.42
November	1.06	7.29	7.56	1.10	7.49	7.65
December	1.10	7.59	8.29	.91	6.21	8.11
Total	14.50	100.00	100.00	14.72	100.00	100.00

[R. 71].

The method of accounting employed by petitioner with respect to prepaid membership dues was designed to result in matching during the same accounting period the cost of serving its members with the related revenue derived from such members. [R. 68, 69].

The method of accounting employed by petitioner during the years in issue has been used regularly by petitioner since 1931 and was used both before and after petitioner was required to pay federal income taxes. [R. 66].

The method of accounting employed by petitioner during the years in issue is in accord with generally accepted commercial accounting principles and practices, is customarily and generally employed in the motor club field, and in the opinion of qualified experts

in the accounting field, reflects petitioner's net income clearly. [R. 18, 19, 26, 66].

Had the petitioner recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of twelve months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed. [R. 68, 69].

Petitioner's income tax return for the calendar year 1952 reflected net income of $152,975.51. [R. 60]. Petitioner's income tax return for the calendar year 1953 reflected net income of $352,125.84. [R. 60]. The 1954 tax return reported a net operating loss in the amount of $290,184.04. [R. 60].

Upon audit of petitioner's federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue determined not to recognize for the calendar years 1953 or 1954 the method of accounting employed by petitioner with respect to prepaid membership dues and prepaid membership costs, which is the issue in this proceeding. The Commissioner determined that all prepaid membership dues should be reported as income in the year of receipt. The net effect of such determination was to increase petitioner's 1953 net income to $481,557.59 and reduce petitioner's 1954 net operating loss to $14,412.49. [R. 60].

As a result of the adjustments described above, the Commissioner of Internal Revenue asserted deficiencies in income tax for the calendar year 1952 in the amount of $58,083.58, and for the calendar year 1953 in the amount of $137,907.48. [R. 61, 62]. In May, 1956, these deficiencies in tax plus interest were paid by petitioner. [R. 62]. Petitioner filed timely claims for refund within two years and following rejection of such claims commenced suit July 8, 1958. [R. 1, 62].

SUMMARY OF ARGUMENT

The Internal Revenue Code not only permits, but requires, that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."[1] Both in keeping its books and records and in filing its tax returns, petitioner reported annual prepaid membership dues as "income", over the period of time that services were rendered or made available, rather than entirely in the taxable year of receipt—in accordance with generally accepted principles of accrual accounting. Use of the accrual method of accounting is expressly authorized by Section 446(c)(2) of the Internal Revenue Code of 1954, and has been approved by every Revenue Act since 1916, provided only that income is clearly reflected. The purpose of accrual accounting is to permit the matching of income with related costs in the same taxable periods.[2] Section 451 of the 1954 Internal Revenue Code, and a corresponding provision of all Revenue Acts since 1918 recognizes that an item of income may be properly

[1] Int. Rev. Code of 1954, Sec. 446(a).

[2] *United States* v. *Anderson*, 269 U.S. 422, 440.

accounted for in a taxable year *different* from the year of receipt. The decisions of this Court recognize that under accrual accounting it is not *the actual receipt* of money that determines the time of its inclusion in income.[3]

The Regulations of the Treasury Department expressly provide that "a method of accounting which reflects the consistent application of generally accepted accounting principles . . . will ordinarily be regarded as clearly reflecting income. . . . ."[4] The court below found as facts, *inter alia*, that petitioner's method of accounting was used regularly since 1931, was in accord with "generally accepted commercial accounting principles",[5] resulted in a precise matching of expense and related revenue, since the computation of petitioner's income would have been "substantially the same" if advance dues were reported as income when related costs were actually incurred,[6] and was more "practicable" than assigning advance dues to income as costs were actually incurred.[7]

The Commissioner of Internal Revenue is not empowered to force petitioner to change its long standing method of accrual accounting, unless its method of accounting fails to reflect income clearly.

Petitioner's method of accounting does reflect its income clearly because it is in accord with generally

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[3] *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182 (1934); *Hansen* v. *Commissioner*, 360 U.S. 463 (1959).

[4] Treas. Reg., sec. 1.446-1(a)(2) (1957).

[5] Finding 22, R. 66.

[6] Finding 26, R. 69.

[7] Finding 28, R. 69.

accepted accounting principles and results in matching in the same taxable periods advance dues received from members with the related costs of serving such members which is the essential purpose of accrual accounting.

ARGUMENT

1. The starting point in determining whether a method of accounting is acceptable for federal income tax purposes is whether the method of accounting reflects income clearly.

The solution to the problem of whether a pro rata part of advance dues may be reported as taxable income later than the year of receipt depends upon a construction of Sections 41 and 42 of the Internal Revenue Code of 1939 and Sections 446 and 451 of the Internal Revenue Code of 1954. Section 446(a) of the 1954 Code and corresponding sections of prior revenue acts require that:

> "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."

Section 451 of the 1954 Code and corresponding provisions of prior revenue acts provide that:

> "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.*" (Italics supplied.)

Since the Commissioner of Internal Revenue contends that petitioner's method of deferral of advance dues is not one of the methods of accounting permitted under Section 446, the first point to be considered is

the standard by which a method of accounting which is acceptable for tax purposes may be identified. Clearly Section 446(c) of the Internal Revenue Code of 1954 and corresponding provisions of prior revenue acts expressly authorize the use of "an accrual method" of accounting.

Section 446(b) of the 1954 Code further provides that:

> "If no method of accounting has been regularly used by the taxpayer, or *if the method used does not clearly reflect income*, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income." (Italics supplied.)

The quoted provision contains the only enumerated basis upon which the Commissioner of Internal Revenue may disallow a method of accounting. The problem therefore must be to identify the standard which must be applied to determine whether petitioner's accrual method of accounting does or does not clearly reflect its income.

The accrual method of accounting was not permitted for federal income tax purposes until the Revenue Act of 1916[8] and was authorized "apparently in response to mounting pressure from economists and businessmen to create some coherence in the relation between accounting for income and for income taxation. . . ."[9]

Section 13(d) of the 1916 Revenue Act provided as follows:

> "A corporation . . . keeping accounts upon any basis other than that of actual receipts and dis-

[8] 39 Stat. 756-77 (1916).

[9] May, "Accounting and the Accountant in the Administration of Income Taxation," 47 Colum. L. Rev. 377, 380-381 (1947).

bursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned."[10]

In describing the purpose of the above-quoted amendment, the Report of the Committee on Ways and Means of the House of Representatives explained:

> "As two systems of bookkeeping are in use in the United States, one based on the cash or receipts basis and the other on the accrual basis, it was deemed advisable to provide in the proposed measure that an individual or a corporation may make a return on either the cash or accrual basis if the method selected clearly reflects the income."[11]

It will be noted that original Congressional approval of accrual accounting bestowed upon the Commissioner of Internal Revenue wide discretion with respect to its use. Only if the corporation kept its books on the accrual basis, if the cash basis did not reflect income clearly, and if the method of accrual accounting complied with the Commissioner's regulations was its use acceptable for income tax purposes.

With the enactment of the Revenue Act of 1918, however, the situation was reversed and a taxpayer who employed the accrual method of accounting in keeping its books and records was not only permitted, but required, to file its federal income tax returns on the same basis. The authority of the Commissioner of

[10] 39 Stat. 771 (1916).

[11] H. R. Rep. No. 922, 64th Cong., 1st Sess. 4 (1916).

Internal Revenue to disapprove the use of a method of accounting was limited to those cases where the method employed failed to reflect income clearly. The language of Section 212(b) of the 1918 Act, which has remained unchanged in substance until the present time, was as follows:

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income."[12]

Section 213(a) of the Revenue Act of 1918 was the original source of the provision that:

> "The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, *unless . . . any such amounts are to be properly accounted for as of a different period*; . . ."[13] (Italics supplied.)

In a decision of the United States Board of Tax Appeals rendered February 28, 1925, these legislative developments were reviewed as follows:

> "We thus see the steady development, through the Acts passed by Congress from 1909 to 1918, of the concept of measuring income either upon a cash receipts and disbursements basis or upon the accrual basis. We see how slowly Congress moved

[12] 40 Stat. 1064, 1065 (1918).

[13] 40 Stat. 1065 (1918).

away from the cash receipts and disbursements basis unequivocally laid down in the Act of 1909 through the grudging admission of the alternative accrual basis in 1916 and 1917 to the absolute requirement of the alternative basis as set forth in the Act of 1918."[14]

This Court first surveyed the legislative development through 1916 in *United States* v. *Anderson*, and concluded that the accrual method of accounting was authorized

> "to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income *earned* during the taxable period, the expenses incurred in and properly attributable to the process of *earning* income during that period . . . ."[15] (Italics supplied).

This principle was applied to require a taxpayer, which employed the accrual method of accounting, to accrue in 1916 in advance of payment, munitions taxes imposed for the year 1916 but not payable until 1917.

The Regulations of the Treasury Department explain the standards by which a method of accounting which is acceptable for federal income tax purposes may be identified, as follows:

> "A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income. . . ."[16]

[14] *Henry Reubel*, 1 B.T.A. 676, 678 (1925).

[15] 269 U.S. 422, 440 (1926).

[16] Treas. Reg., sec. 1.446-1(a)(2) (1957).

Similarly, under the 1939 Code provisions, the applicable regulations were:

> "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income."[17]

The starting point therefore is the standard of "scientific accounting principles" to determine whether the deferral method here employed by the petitioner did or did not "reflect its income clearly."

2. Petitioner's method of deferral of prepaid dues was in accord with generally accepted accounting principles.

There are three basic principles of accrual accounting which require the method of deferral employed by petitioner in this case.

The first accounting principle involves the distinction between a "financing" transaction and an "income or revenue" transaction.

The American Automobile Association was incorporated without capital stock of any kind. As a nonstock, membership corporation it is different from most other business organizations. A different approach to financing its activities is therefore required. Most business corporations obtain financing through the issuance of stock or by loans obtained from banks, insurance companies or other lenders. Since petitioner has no capital stock, this source of financing is unavailable to it. In its divisions petitioner obtains funds with which to operate by means of a third type of financing transaction—i.e., advances from members. Th vances are in the form of prepaid membership d

[17] Treas. Reg. 118, sec. 39.41-2(a) (1953).

Under generally accepted accounting principles money obtained in a financing transaction whether by issuance of stock or by loan from institutional or other lenders or by advances from members or customers is regarded as a liability upon receipt.

It is for this reason that dues collected in advance of the rendition of services are posted to a liability account.

The second basic principle of accrual accounting is that "income", or revenue as the accountants describe it, emerges only as goods are delivered or services are rendered. In other words, what goes on line (1) of an income statement in the case of a service organization such as petitioner is the value of services which are rendered or made available. Under accrual accounting, it is performance which results in realization of income. Typical quotations from recognized accounting textbooks discussing the above accounting principles are as follows:

> ". . . all customer advances are clear-cut liabilities. When he deposits funds before receiving goods or services, the customer is in effect extending credit to the vendor. . . . Revenue arises as the product is delivered; receipt of cash in itself does not establish the existence of revenue. These basic facts should not be overlooked in setting up the pattern of accounting for such transactions.
>
> ". . . Advances represent neither earned nor realized revenue and to levy income taxes on such amounts violates accounting principles and basic legal rules, including the underlying structure of tax law itself. It would be scarcely more unreasonable to hold that money borrowed from a bank is income than to insist that money advanced by a customer must be so treated."[18]

[18] Paton & Dixon, Essentials of Accounting, 211-212 (1958).

Similarly, in the "Accountants' Handbook" which for many years has been considered the standard reference work on accounting principles, the paragraph entitled "Deferred Revenues" states:

> "Deferred revenues appear when collection is made in whole or in part prior to the actual furnishing of service or transfer of title to goods. An outstanding example is found in the insurance field where premiums are regularly collected in advance for a considerable period. 'Advances by customers' is usually a better description for statement purposes than 'deferred revenues.' "[19]

Under the heading "Advances by Customers" Harold Bierman, Jr., writes:

> "When a customer makes a payment in advance of the service to be performed, this creates a liability on the part of the company receiving the payment."[20]

Finney and Miller, authors of a textbook series used by hundreds of colleges and universities, state:

> "The portion of revenue collected in advance that has not been earned at the end of the accounting period remains in an unearned revenue account, where it represents an obligation to be satisfied, not by the payment of money, but by the rendering of service."[21]

Roy B. Kester, author of "Principles of Accounting," Ronald Press Co., New York, 1939, states at page 518 that the "unearned income" account:

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[19] Wixon & Kell, Accountants' Handbook, sec. 20, 3-4 (1956).

[20] Bierman, Managerial Accounting, 112 (1959).

[21] Finney & Miller, Principles of Accounting—Introductory (1957).

> "... reflects the liability of the business to render to the customers, i.e., the payers or contributors of the income, the service or commodity paid for by them in advance. The account is a true liability account and will be carried in the ledger in the liability section. At the end of each month, or other fiscal period, the portion of this income estimated as equitably belonging to the current period will be transferred from the unearned income account to an appropriate income account ..."

As these principles of accounting are applied to a motor club, it becomes apparent that when a member pays dues in advance for services to be rendered during a future period of time, the advance dues upon collection must be reflected in a liability account—not an income account. Thereafter, a pro rata part of the advance dues must be removed from the liability account and reflected in an "income" account of the motor club as the obligation of the club to the member is satisfied by performance or as the obligation expires. At the end of the annual accounting period, that portion of advance dues for which services have not yet been rendered and for which costs have not yet been incurred remains in the liability account until the following year when performance takes place, or the obligation expires.

The third cardinal principle of accrual accounting, which is consistent with the two preceding principles, and which has been expressly approved by this Court,[22] is as follows:

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[22] *United States* v. *Anderson*, 269 U.S. 422 (1926); *Lewyt Corp.* v. *Commissioner*, 349 U.S. 237, 242-243 (1955).

> "The recognized purpose of accrual accounting is to determine income properly by matching appropriate costs against related revenues."[23]

Only if the costs incurred by petitioner in serving its members are matched in the same taxable periods with related prepaid dues received from its members can it be determined whether petitioner earns any income at all.

While this Court, obviously, is not bound to consider all of the niceties of accrual accounting in interpreting federal income tax statutes, the cardinal principles of accounting should not be ignored where the applicable statutes and regulations are phrased in accounting terms, and where the issue involved is whether income is clearly reflected.

Petitioner directs the attention of this Court to these three basic principles of accrual accounting in confirmation of the finding of fact made by the court below that its method of accounting does conform with standard commercial accounting principles, and in support of the conclusion of the Commissioner of the Court of Claims that petitioner's method of accounting for prepaid dues reflects its income clearly.

The court below also found as a fact that the costs incurred by petitioner in serving its members were in proportion to membership from year to year with reasonable constancy from month to month. The average cost incurred by petitioner in serving one member per month was relatively constant.

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[23] Freeman, "Tax Accrual Accounting for Contested Items," 56 Mich. L. Rev. 727, 728 (1958). See also Shannon, Legal Accounting 162 (1951); Paton, Accountant's Handbook, 113 (1950); Finney & Oldberg, Lawyer's Guide to Accounting, 78 (1955).

Since petitioner files its income tax returns on a calendar year basis, but its members join and prepay dues for a twelve month period which does not coincide with petitioner's calendar year, it is obvious that appropriate costs cannot be matched with related revenues unless advance dues are recognized as income over the membership period rather than entirely in the year of receipt. For example, if a member joins on July 1 of a calendar year and prepays annual dues of $15.00, and if the costs incurred by petitioner in serving its members average $1.20 per member per month, or $14.40 per member for a twelve month period, true income will not be clearly reflected unless $7.50 of advance dues is reported as income in the calendar year the member joined, and the remaining $7.50 in the following calendar year. Under accrual accounting, petitioner earns a profit of 60 cents from this membership, half of which is reported as income in the year the member joined and the remaining half in the following calendar year. By contrast, under the method of accounting which the respondent seeks to impose upon petitioner, petitioner would report $15.00 as taxable income in the calendar year the member joined; actual costs incurred in such year in serving such member would equal only $7.20 ($6 \times 1.20 = \$7.20$); therefore a fictitious profit of $7.80 would be subjected to federal income taxes.

Obviously under the respondent's method of accounting there is no matching of appropriate costs with related prepaid dues, which is the cornerstone of accrual accounting.

Since this is not a case where petitioner seeks to change its method of accounting, but a case where

petitioner has regularly employed the same method of accrual accounting for many, many years, petitioner contends that in order to prevail, it need prove only that the respondent was incorrect in asserting that petitioner's method of accounting fails to reflect income clearly. This petitioner has done.

3. The principles of accrual accounting as enunciated by this Court support petitioner's position

The principles governing the reporting of income by taxpayers who employ the accrual method of accounting have often been considered by this Court. In *Brown* v. *Helvering*,[24] this Court pointed out:

> "If the accounts are kept on the accrual basis the income is to be accounted for in the year in which it is realized even if not then actually received; and the deductions are to be taken in the year in which the deductible items are incurred."[25]

In *Spring City Foundry Co.* v. *Commissioner*,[26] this Court differentiated between reporting income on the cash receipts and the accrual methods of accounting as follows:

> "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive *and not the actual receipt* (italics supplied) that determines the inclusion of the amount in gross income. When the *right* to receive an amount becomes fixed, the right accrues. When a merchandising concern

[24] 291 U.S. 193 (1934).

[25] 291 U.S. at 199.

[26] 292 U.S. 182 (1934).

> makes sales, its inventory is reduced and a claim for the purchase price arises.'"[27]

This principle was reiterated by this Court in *Security Flour Mills Co.* v. *Commissioner*,[28] and again emphasized in the recent decision of *Hansen* v. *Commissioner*.[29]

In all of these cases the taxpayer was required to report taxable income before the actual receipt of cash.

(a) Under accrual accounting the time when cash is received does not govern the time of its inclusion in income

This Court has made it unmistakably clear that in accrual accounting the time when cash is actually received does not control the time of its inclusion in gross income for tax purposes. Since this is a correct principle of accrual accounting where cash is received after the year the profit is realized, it is equally sound where cash is received before the year in which the profit is realized.

Accrual accounting would be a trap for the taxpayer and an unfair one way street for the Government if the respondent prevails in this case, for the respondent contends that despite the principles of accrual accounting as laid down by this Court, it is the actual receipt of cash that is controlling for tax purposes in this case.

Stated another way, the respondent's contention is that an accrual basis taxpayer must report cash as taxable income either on the cash receipts basis or on

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[27] 292 U.S. at 184, 185.

[28] 321 U.S. 281 (1944).

[29] 360 U.S. 463 (1959).

the accrual basis, whichever gives the respondent the earliest opportunity to collect the income tax and irrespective of whether the taxpayer's income is reflected clearly. Certainly this one way street is not in accord with principles of sound accrual accounting, and not in accord with the decisions of this Court.

Further analysis of these cases permits identification of the events which must occur in order for an accrual basis taxpayer to earn income. In *Brown* v. *Helvering, supra,* it was explained that under accrual accounting:

> "... income is to be accounted for in the year in which it is *realized*. ..."[30] (Italics supplied.)

In *Spring City Foundry Co.* v. *Commissioner, supra,* this Court, in describing the events which required accrual of income, stated:

> "When a merchandising concern makes sales, its inventory is reduced and a claim for the purchase price arises."[31]

which event fixed the right of the taxpayer to income.

In other words, in the case of an accrual basis merchandising concern not only sales but delivery, i.e., reduction of inventory, must have occurred for the taxpayer to have realized income. By analogy, in the case of an accrual basis service organization such as the American Automobile Association, the furnishing or making available of services must occur for taxable income to be realized.

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[30] 291 U.S. at 199.

[31] 292 U.S. at 185.

(b) Under accrual accounting, an item of expense may be deducted in a year different from the year of payment

From the deduction point of view as well as from the income point of view, the purpose of accrual accounting is to reflect true economic income. In discussing true income under accrual accounting, this Court, in *United States* v. *Anderson, supra,* laid down a principle with respect to the accrual of liabilities which is often referred to as the "all events" test. The taxable year in which a munitions tax accrued was determined as follows:

> "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing an appellee's books. In the economic and bookkeeping sense with which the statute . . . [was] concerned, the taxes had accrued."[32]

Petitioner argues that a necessary corollary to the "all events" test established in the *Anderson* case should be applied where prepaid receipts are involved. The corollary would be that until substantially all events have occurred in connection with prepaid receipts, which would include incurring the costs essential to satisfy the obligation for which the prepaid money was received, the true income of a taxpayer is distorted unless prepaid receipts are reported as income in a

[32] 269 U.S. at 441.

manner which results in matching the cost of performance with related revenue.

In *Security Flour Mills Co.* v. *Commissioner*, *supra*, this Court made it clear that under accrual accounting the deduction of an item of expense could *follow* payment as well as *precede* payment under proper circumstances.

In that case, this Court referred to Section 43 of the 1939 Code[33] which provided that:

> "The deductions and credits . . . provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred', dependent upon the method of accounting upon the basis of which the net income is computed, *unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. . . .*" (Italics supplied.)

The origin of the above-quoted provision was traced by this Court to Section 200(d) of the Revenue Act of 1924, the legislative history of which was quoted as follows:

> "The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should."[34]

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[33] 53 Stat. 24 (1939). The 1954 Code counterpart is Section 461.

[34] H. Rep. No. 179, 68th Cong., 1st Sess. 10, 11 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 10, 11 (1924).

Surely, if under accrual accounting the accrual of an item of expense can follow payment, as is clearly true in the case of prepaid expenses, the accrual of income must likewise follow receipt where prepaid receipts are involved.

Where money is received by a taxpayer in advance of the rendition of services for which substantial costs must be incurred, such money is either totally or partially unearned and should not represent taxable income. Clearly the concept of prepaid receipts requires consideraation of factors which are not present in dealing with concededly earned income. The issue involved in this case therefore represents a different type of problem from any which has been considered on the merits by this Court.

(c) The claim of right doctrine as enunciated by this Court is not applicable to this case

The "claim of right" doctrine as enunciated by this Court deals with the year in which an item of *earned income* must be reported for tax purposes even though there is a possibility the taxpayer cannot keep the income. These cases individually, or collectively as they establish the so-called "claim of right" doctrine, do not stand for the proposition that prepaid receipts must be reflected as taxable income before the product is delivered, before the services have been rendered, or before the costs have been incurred.

The claim of right doctrine appears to have been first applied in a tax case by this Court in *North American Oil Consolidated* v. *Burnet*.[35] In that case the taxpayer and the government disputed the owner-

[35] 286 U.S. 417 (1932).

ship of certain oil properties. A receiver was appointed pending a determination. In the year 1916, under the control of the receiver, the oil wells were operated at a net profit. In 1917 the court battle was resolved in the taxpayer's favor at the trial level and consequently the receiver paid over the sums representing 1916 profits to the taxpayer. The taxpayer sought to treat this profit, which was conceded to be net profit, as taxable income in the year 1916.. The Commissioner asserted that the profits were taxable in 1917 when North American Oil first had possession. Taxpayer countered with the argument that if the profits were not taxable to it in 1916, they should not be taxable until 1922 when its right to retain the profits became final on disposition of an appeal by the Government to the appellate courts. This Court held that the net profits earned in 1916 were not taxable to petitioner in 1916 since it "was not required to report as income an amount which it might never receive." As between the remaining years 1917 and 1922 this Court held the income taxable in 1917, explaining its reasons as follows:

> "If a taxpayer receives *earnings* under a claim of right and without restriction as to its disposition, he has received income which he is required to return even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."[36] (Italics supplied.)

It is clear that the facts in *North American Oil Consolidated* v. *Burnet*, *supra*, are not applicable by analogy to this case, for here the advance dues received by petitioner were not earned since petitioner was re-

[36] 286 U.S. at 424.

quired to make substantial expenditures in order to render services in the year following receipt of such dues.

In *Brown* v. *Helvering, supra,* the taxpayer was a general agent for insurance companies and received commissions on policies, the terms of some of which extended beyond one year. If a policy was canceled, Brown was required to refund a proportionate part of the commission to the insurance company. Under Brown's method of accounting, he treated all commissions as income in the year received, and if a policy were canceled, he deducted the refund as an expense in the year paid. He sought to change his method of accounting in order to charge to expense in the year in which a commission was received an estimated reserve representing refunds that might have to be made in the future. This Court held that Brown was not entitled to take a current deduction for contingent refunds he might have to make in future years.

But Brown made an alternate contention—that the cash commissions received should have been included as gross income on a deferred basis pro rata over the life of the policy. As to his alternate contention, this Court held against Brown for two significant reasons:

First, the Court pointed out that Brown had never kept his books of account on that basis as required by statute.

Second, this Court explained:

> "Moreover, the Board concluded that there 'is no proof that the overriding commissions contain any element of compensation for services to be rendered in future years.'"[37]

[37] 291 U.S. at 204.

In *United States* v. *Lewis*,[38] the taxpayer in 1944 received a bonus as compensation for services rendered as an employee. Subsequently, due to error detected after the close of the year, Lewis was required to return a part of the bonus following litigation over the matter. This Court required the taxpayer to report the bonus as taxable income when received. A deduction would be allowable in the subsequent year of repayment.

In cases of this type no services remain to be rendered and no expenses remain to be incurred.[39]

4. The position of the Respondent is contrary to the regulations of the Treasury Department, and to recent decisions of the United States Courts of Appeal

The Commissioner's own regulations promulgated pursuant to the provisions of Sections 446 and 451 of the Internal Revenue Code of 1954 provide as follows:

> "It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. *A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross in-*

[38] 340 U.S. 590 (1951).

[39] Cf. *Rutkin* v. *United States*, 343 U.S. 130 (1952); *Healy* v. *Commissioner*, 345 U.S. 278 (1953).

come and expense are treated consistently from year to year." [40] (Italics supplied.)

Similarly, under the 1939 Code the Regulations contain the following statement:

"*Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.* A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. . . . All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. . . ." [41] (Italics supplied.)

The early position of the Commissioner of Internal Revenue was in accord with petitioner's interpretation of the law.

In I.T. 2080,[42] the taxpayer was a travel agent engaged in the business of running various cruises and tours. In the last two months of the year the taxpayer received substantial deposits for tickets in connection with cruises which were to take place the following year. The Bureau ruled that the taxpayer was required to employ the accrual method of accounting in order to reflect its income clearly and was required to defer the inclusion in income of advance payments received from customers until the year in which the

[40] Treas. Reg., sec. 1.446-1(a)(2) (1957).

[41] Treas. Reg. 118, sec. 39.41-2(a) (1953).

[42] III-2 Cum. Bull. 48 (1924).

expenses involved in operating the cruise would take place.

In I.T. 3369 the Commissioner noted that two methods of accounting were followed by publishers of periodicals. Under the first method the publisher reported income from prepaid subscriptions in the year of receipt. Under the second method prepaid subscription income was deferred as taxable income until the year the newspaper, magazine or other periodical was published and delivered. The Commissioner ruled:

> "It is held that where a publisher of periodicals has, over a period of years, followed consistently either of the two methods outlined above, he may continue to file his returns on such basis, he will not be required to change to the other basis, and his net income for the past years will not be redetermined on such other basis."[43]

For many, many years the Commissioner with no statutory authority except Sections 446 and 451 of the 1954 Code and corresponding provisions of prior revenue acts, has approved two methods of accounting for income derived from "long term contracts" which are consistent with sound accrual accounting practices and which support petitioner's position in principle. Long term contracts, however, are defined by the Commissioner to mean only "building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and

[43] 1940-1 Cum. Bull. 46, 47.

accepted.'"[44] Where long term contracts are involved a taxpayer can employ either the "percentage of completion" method of accounting or the "completed contract method." Under either method advances or prepayments are reported as income later than the year received by the taxpayer. For example, if a builder contracts to construct a $100,000 building and receives a $40,000 down payment, the $40,000 down payment is not reported as taxable income until the costs of completing the building are incurred, or at least until a pro rata part of the costs are incurred—provided the contract extends for a period of more than twelve months.

The Commissioner's "long term contract regulations" do not expressly apply to a building contract involving a period of less than twelve months. If the contract previously described was entered into in December, and the builder was a calendar year taxpayer, and if the building involved were completed in less than twelve months, the $40,000 down payment would presumably constitute taxable income in the year of receipt unless the statutes, regulations and accounting principles upon which petitioner relies are applicable. A ridiculous result is produced if the builder, upon completion of the building, actually earns a profit of $1,000 or incurs a loss. There is no decided case where the Commissioner has taken this extreme position in the case of a builder, yet such a position would be totally consistent with the Commissioner's position in the case at bar.

In recent years the Commissioner of Internal Revenue has been adamant in holding that regardless of

[44] Treas. Reg., sec. 1.451-3 (1957).

the taxpayer's method of accounting "prepaid income" cannot be deferred beyond the taxable year of receipt because of a long line of judicial authority which allegedly holds

> "that where a taxpayer receives prepaid income under a claim of right and without restriction as to its disposition, it must report the entire amount received each year as income."[45]

However, the United States Courts of Appeal has disagreed with the Commissioner of Internal Revenue more often than not where the taxpayer could prove its method of accounting reflected income clearly.

The current status of lower court decisions on this issue is as follows. The Tax Court, the Court of Appeals for the Sixth Circuit (in *Automobile Club of Michigan* v. *Commissioner*[46]), and the Seventh Circuit (in *Streight Radio & Television, Inc.* v. *Commissioner*[47]) have rendered decisions applying the claim of right doctrine to concededly unearned receipts although absence of proof that the method of accounting clearly reflected income appeared to be the controlling factor in some instances.

The Courts of Appeal for the Second, Eighth and Ninth Circuits have rendered recent decisions fully supporting the deferral of prepaid receipts where the taxpayer has consistently employed the accrual method of accounting and proved that deferral was essential in order to reflect income clearly.

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[45] Rev. Rul. 60-85, 60-10 I.R.B. 14.

[46] 230 F. 2d 585 (6th Cir. 1956), aff'd 353 U.S. 180 (1957).

[47] 280 F. 2d 883 (7th Cir. 1960), (petition for writ of certiorari filed).

The initial decision of a Court of Appeals squarely supporting petitioner's position was *Beacon Publishing Co.* v. *Commissioner.*[48] In that case a publisher not entitled to the benefits of I.T. 3369, *supra,* who received subscriptions payable in advance for a period of several years was permitted to defer the inclusion in income of advance subscriptions until the year when the magazine would be delivered and the cost of publishing the magazine would be incurred. The Court explained its position in the following language:

> "Plainly, Section 42 contemplates that prepaid sums can be returned in a year other than when received. It says that income shall be included in the taxable year received, 'unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period.' This is not a case where the Commissioner has exercised his broad discretion to require a taxpayer to adopt an accounting method which will clearly reflect income, but is one in which he has improperly applied a legal principle."[49]

The leading decision in support of petitioner's position is *Bressner Radio, Inc.* v. *Commissioner.*[50] The *Bressner Radio* case was decided two years subsequent to the decision of this Court in *Automobile Club of Michigan.*

In *Bressner Radio* the taxpayer was in the business of selling television sets and electrical appliances. Its books were kept on the accrual basis of accounting:

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[48] 218 F. 2d 697 (6th Cir. 1955).

[49] 218 F. 2d at 701.

[50] 267 F. 2d 520 (2d Cir. 1959), rev'g 28 T.C. 378 (1957).

its income tax returns were filed on the same basis. As an inducement for a customer to buy a television set in the early days when sets were untried and repairs were numerous, the taxpayer entered into a "service contract" for television receivers under which the taxpayer agreed

> "to service the television receiver . . . and to furnish to the purchaser all labor, replacement of parts and tools . . . necessary to provide proper operation . . . for a period of [twelve months] from the date of this contract." [51]

Contracts were entered into throughout the taxable year. The average price received by taxpayer per contract varied between $80 and $100. Payments were made by most purchasers in installments. Taxpayer discounted most contracts with a bank for cash. Taxpayer's initial cost of installing the television set covered by the contract was approximately 1/4th of its total estimated costs per contract. Taxpayer's experience showed that eight to twelve service calls per set, on the average, were made during the twelve month period during which each contract was in force. Taxpayer reflected as income 25% of the service contract price at the time of installation and spread the balance over the twelve month period of the contract. Services rendered by taxpayer, other than installation, were only at the request of the owner of the set. Taxpayer introduced substantial proof that its method of accounting clearly reflected its income. The Tax Court ignored the evidence and held for the Commissioner, relying upon the claim of right doctrine. The Court of Appeals for the Second Circuit reversed.

[51] 267 F. 2d at 521

holding that the taxpayer's method of accounting clearly reflected its income.

After carefully analyzing the decisions of this Court on accrual accounting, the Second Circuit concluded that the use of "scientific accounting principles" was the cornerstone of tax accounting and tax law, that the claim of right doctrine was not applicable to an accounting problem of this type, and that the decision of this Court in *Automobile Club of Michigan, supra*, was distinguishable for several reasons, including failure of proof by the taxpayer.

The Court then went on to conclude that the taxpayer before it had not used an artificial method of deferral, stating:

> "Drawing on its experience with thousands of contracts it has demonstrated that it was subjected to a reasonably uniform demand for services, so that it could and did anticipate that the expenses incident to the performance which alone would entitle it to regard the sum received as earned would be distributed across the life of the contract. It therefore deferred revenues until they were earned, and thus matched them with foreseeably related expenses, which is the essential purpose of accrual accounting. *United States* v. *Anderson*, 1926, 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347."[52]

The Solicitor General did not apply for a writ of certiorari in the Bressner Radio case.

The most recent case supporting the position of taxpayer is *Schlude* v. *Commissioner*.[53] Taxpayers in that case were husband and wife who formed a part-

[52] 267 F. 2d at 528.

[53] 283 F. 2d 234 (8th Cir. 1960) (petition for cert. filed).

nership to operate Arthur Murray Dance Studios in the midwest. Several types of contracts were entered into between the partnership and students desiring lessons, but in almost all instances the student was required to prepay the cost of future lessons either in the form of cash or by note (lessons for which taxpayers were obligated extended beyond the end of the taxable year). Employing the accrual method of accounting, taxpayers regarded advance payments as a liability upon receipt and included advance payments as "income" as lessons were given or as the obligation to give lessons expired. The Tax Court, applying the claim of right doctrine, held that all cash and all notes must be reported as taxable income fully in the year of receipt. The Court of Appeals for the Eighth Circuit reversed, agreeing whole-heartedly with the opinion of the Second Circuit in *Bressner Radio, Inc., supra.* Said the Eighth Circuit:

> "Even indulging the assumption that petitioners came into possession of the monetary amount of the contracts when executed within the contemplation of the claim of right doctrine, we are satisfied that to apply the doctrine to petitioners' operation, without regard to its accrual system of accounting, would result in emasculation of the law long recognized, which affords taxpayers the right 'to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period.' *United States* v. *Anderson, supra*, 269 U.S. at page 440, 46 S. Ct. at page 134."[34]

[34] 283 F. 2d at 241.

5. The decision of this Court in Automobile Club of Michigan v. Commissioner, supra, should not be controlling here because petitioner has proved its method of accounting reflects its income clearly

The accounting question was only one of three different issues argued before and decided by this Court in *Automobile Club of Michigan, supra.* The opinion of this Court on the accounting issue indicates that its decision was grounded primarily upon the facts—or lack of facts—produced in evidence in that case. In its majority opinion, this Court stated:

> "The pro rata allocation of the membership dues in monthly amounts is purely artificial and *bears no relation to the services which petitioner may in fact be called upon to render for the member.* . . . We cannot say, *in the circumstances here*, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits."[35] (Italics supplied.)

In the *Automobile Club of Michigan* case, no evidence was produced to support the fact that the method of accounting employed by the Michigan Club was in accord with generally accepted accounting principles or clearly reflected its income. No accountants were placed on the stand. Little or no evidence was introduced with respect to the cost of serving the members of the Club or with respect to the correlation, if any, between the cost incurred in serving a member and the period of time over which advance dues were recognized as income. The Tax Court did not find as a fact that the method of accounting employed by the Michi-

[35] 353 U.S. at 189.

gan Club was in accord with accepted accounting principles, as the Court of Claims did in the case at bar.

Without evidence on these points this Court had little choice except to conclude that "in the circumstances here" the Commissioner of Internal Revenue should be upheld.[56]

The conclusion that the decision of this Court in *Automobile Club of Michigan* was grounded upon the facts or lack of facts in that case is fortified by this Court's reference to *Beacon Publishing Company* v. *Commissioner, supra*, and *Schuessler* v. *Commissioner*,[57] both of which were distinguished on their facts. Footnote 20 of the majority opinion reads as follows:

> "Beacon Publishing Co. v. Commissioner (CA 10th) 218 F. 2d 697, and Schuessler v. Commissioner (CA 5th) 230 F. 2d 722, are distinguishable on their facts. In Beacon, performance of the subscription, in most instances, was, in part, necessarily deferred until the publication dates after the tax year. In Schuessler, performance of the service agreement required the taxpayer to furnish services at specified times in years subsequent to the tax year. In this case, substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year. We express no opinion upon the correctness of the decisions in Beacon or Schuessler."[58]

In the case at bar petitioner was able to establish that the recognition of dues as income over the life

[56] 353 U.S. at 753.

[57] 230 F. 2d 722 (5th Cir. 1956).

[58] 353 U.S. at 189, n. 20.

of the membership, was not artificial but was practical and realistic, because a direct relationship existed between the costs incurred in serving its members and the period of time over which advance dues were recognized as income.

Most law review writers who have analyzed the decision of this Court in *Automobile Club of Michigan* concluded that this Court would approve a realistic deferral of prepaid income if the taxpayer's income was reflected clearly.[59]

6. The method of accounting employed by petitioner does reflect its income clearly

As the principles of accrual accounting discussed in this brief are applied to prepaid dues received by the petitioner from its members, it becomes clear that such dues upon collection constitute a liability, not income. The liability diminishes and income arises as the obligation of petitioner to its members is satisfied by performance or as the obligation expires. At the end

[59] Behren, "Prepaid Income Accounting Concepts and the Tax Law," 15 Tax L. Rev. 343, 359, 360 (1960) states:

> "The Supreme Court implied that a realistic deferral would have been permissible and found only that no realistic deferral had been made. Thus the issue of the inclusion of prepaid income, *properly allocated* to future periods, in current taxable income was not passed upon by the Supreme Court."

In Note, "Taxation of Prepaid Income: a Temporary Solution," 67 Yale L. J. 1425, 1440 (1958) it is stated with respect to the *Michigan Club* case:

> ". . . Thus, an automobile club could defend its method of allocating any individual's dues by demonstrating the average services requested by a member for a particular period."

See Note, 59 Col. L. Rev. 942, 944 (1959); Note, 1960 Duke L. J. 127, 131-134.

of each annual accounting period the portion of advance dues for which services have not yet been rendered and for which costs have not yet been incurred must continue to be reflected as a liability until the next year when performance takes place or the obligation expires. Only by this procedure will true income be clearly reflected.

A member of a motor club buys in essence the availability of motor and traveling service—and protection against common motoring mishaps. The liability of the club to the member is satisfied as time expires whether or not the member uses the club. As the obligation of the club to serve its members expires, advance dues received from members must be reflected by the club as income or revenue. There may be members of a motor club who hope they will never have to use some of its services, particularly emergency road service. This does not mean, however, that the club does not incur expenses in behalf of such members for the club at all times must incur the costs necessary to maintain the availability of services. To make its services available the club must pay the salaries of its officers and employees, pay the operating expenses of its headquarters and incur numerous other expenses simply because its members have the right to use the club.

Petitioner is able to predict with a high degree of accuracy the costs which it will incur in serving its members on a monthly or annual basis.

At the trial of this case petitioner's testimony consisted of that of its staff auditors, supplemented by outstanding certified public accountants testifying as experts who were familiar with petitioner's problem

or had some direct association with it and whose qualifications were not challenged.

Based upon such testimony and the documentary evidence produced by petitioner, the Commissioner of the Court of Claims before whom the case was tried made the following findings of fact, among others:

> "The advance payment on a service contract, or any other type of contract, does not constitute income or revenue to the recipient, although the acceptance thereof creates a liability to perform. Under generally accepted accounting principles, the accounting for the funds received in advance must be recorded as a liability of the recipient. The plaintiff did this consistently since 1931. These membership contracts entitled the members to receive membership services over a period of 12 months from the date of subscription and acceptance. . . .
>
> "The method of accounting employed by plaintiff was in accordance with accepted accounting principles. The assignment and transfer of funds from the prepaid dues account to revenue or gross income measured over the period of the membership contracts is found to be the most realistic method for properly recording gross income from dues."[60]
>
> "On the evidence presented, the recognition and assignment of prepaid dues ratably over the period of membership is found to be the most realistic and practical method of accounting for gross income from membership dues."[61]
>
> "The plaintiff's liability for servicing members whose membership continued beyond the current

[60] Finding 25, R. 21, 22.

[61] Finding 29, R. 24.

year when dues were paid was not a 'contingent' liability. It was a true liability and the costs were substantially in proportion to membership from year to year with reasonable constancy from month to month. . . ."[62]

"The plaintiff's liability to members for that portion of their memberships which extended beyond the current year in which plaintiff collected the dues in advance is not gross income from membership dues because it was paid and received for a later year. Neither can it be net income in the year when the dues were received because the cost of servicing such memberships could not be performed until the following year when such net income would be realized.

"The method of accounting employed by the plaintiff during the calendar years 1953 and 1954 and prior years in keeping its books and records clearly reflected its net income for such years. The plaintiff's income tax returns for 1953 and 1954 were prepared in accordance with the method of accounting employed in keeping its books and records and clearly reflected the net income for these years. This conclusion and the findings set forth above are supported by the overwhelming weight of the documentary evidence and expert testimony."[63]

And with respect to the so called method of accounting which the Commissioner of Internal Revenue seeks to force upon petitioner, the Commissioner of the Court of Claims made the following findings of fact:

(1) ". . . This application of the receipt of funds as income is contrary to generally accepted accounting principles and practices."[64]

[62] Finding 31, R. 24, 25

[63] Finding 33, R. 26.

[64] Finding 24, R. 20.

(2) "... the adjustments by the Commissioner of the Internal Revenue Service, reflects an overstatement of surplus for 1953 of $1,358,003.10, or approximately 54% in excess of the true surplus."[65]

(3) "By applying similar adjustments to plaintiff's balance sheet as of December 31, 1954, the surplus would be increased and overstated by $1,634,840.81, or approximately 99 percent, and would omit plaintiff's liability to members for a similar amount."[65]

(4) "The evidence establishes that reputable members of the accounting profession would not certify to the accuracy of the income statements and the balance sheets reflecting the adjustments by the Commissioner of the Internal Revenue Service."[65]

Some of these findings were not included by the Court of Claims in its findings of fact, but the Court itself did find the following facts:

"The plaintiff's costs for servicing members were substantially in proportion to membership from year to year with reasonable constancy from month to month. . . ."[66]

"The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices. . . ."[67]

"Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the member-

[65] Finding 24, R. 21.

[66] Finding 30, R. 70.

[67] Finding 22, R. 66.

> ship period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed."[68]

Since the petitioner in the case at bar established by clear and uncontradicted evidence that its method of accounting was not artificial and did clearly reflect its income, these findings should dispose of the case in petitioner's favor.

The decision below is inconsistent with the primary findings of fact made by the Court of Claims, which situation calls for an exercise of this Court's power of supervision as in *United States* v. *Penn Foundry & Mfg. Co.*[69]

In view of the facts established in this case, petitioner respectfully urges this Court not to lay down a broad, sweeping rule of law that under no circumstances may funds collected in advance of performance by an accrual basis taxpayer be reported as taxable income later than the year of receipt. Nor does petitioner request this Court to hold that prepaid receipts may always be deferred—unless necessary to match appropriate costs with related revenue and to reflect income clearly. Petitioner merely requests that the decision of this Court be rendered in the light of existing statutes as applied to the facts proved in this case.[70]

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[68] Finding 26, R. 68.

[69] 337 U.S. 198 (1949).

[70] See *Commissioner* v. *Duberstein*, —— U.S. ——, 4 L. Ed. 2d 1218 (1960); *Stanton* v. *United States*, —— U.S. ——, 4 L. Ed. 2d 1218 (1960); *United States* v. *Kaiser*, —— U.S. ——, 4 L. Ed. 2d 1233 (1960).

CONCLUSION AND RELIEF REQUESTED

Petitioner respectfully requests this Court to hold that in the circumstances here petitioner has proved its method of accounting clearly reflects its income and accordingly is acceptable for tax purposes. Petitioner therefore prays that the judgment entered by the court below should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code 1939:

"SEC. 41. GENERAL RULE.

"The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *"

"SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

"* * * The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *"

Regulations 118:

"§ 39.41-1 *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a

manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

"§ 39.41-2 *Bases of computation and changes in accounting methods.* (a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of 'paid or accrued' and 'paid or incurred.' All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. * * *

* * * *

"§ 39.42-1 *When included in gross income.*—(a) *In general.* Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. See §§ 39.41-1 to 39.41-3, inclusive. * * *"

Internal Revenue Code of 1954:

"SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

"(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

"(c) *Permissible Methods.*—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

"(d) *Taxpayer Engaged in More Than One Business.*—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

"(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

"SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

"(a) *General Rule.*—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

"(b) *Special Rule in Case of Death.*—In the case of the death of a taxpayer whose taxable income is computed under an accrual method of accounting, any amount accrued only by reason of the death of the taxpayer shall not be included in computing taxable income for the period in which falls the date of the taxpayer's death."

Regulations Promulgated Under the 1954 Code:

"§ 1.446-1 (T.D. 6282, filed 12-24-57.)

"*General rule for methods of accounting*—(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term 'method of accounting' includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or

change of accounting methods, see section 446(e) and paragraph (e) of this section.

"(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

"(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461 and the regulations thereunder.

* * * *

"§ 1.451-1 (T.D. 6282, filed 12-24-57.)

"*General rule for taxable year of inclusion*—(a) *General rule.*—Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compen-

sation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and § 1.706-1(a). If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom."

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No. 288

In the Supreme Court of the United States

OCTOBER TERM, 1960

AMERICAN AUTOMOBILE ASSOCIATION, PETITIONER

v.

UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

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In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 288

AMERICAN AUTOMOBILE ASSOCIATION, PETITIONER

v.

UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION BELOW

The opinion of the Court of Claims (R. 51–71) is reported at 181 F. Supp. 255.

JURISDICTION

The judgment of the Court of Claims was entered on March 2, 1960. (R. 51.) The order denying the taxpayer's motion for rehearing and for amendment of findings of fact and conclusion of law was entered on May 4, 1960. (R. 82.) The petition for a writ of certiorari, filed on August 2, 1960, was granted on October 10, 1960. (R. 83.) The jurisdiction of this Court rests upon 28 U.S.C. 1255.

QUESTION PRESENTED

Whether the court below correctly sustained the Commissioner's determination that the taxpayer, filing its income tax returns on the calendar year-accrual basis, was required to report annual membership dues as gross income in the respective taxable years in which the dues were received, undiminished by a contingent liability reserve set up on taxpayer's books to reflect estimated expenses which it anticipated would be incurred in a subsequent year in performing services for its members.

STATUTES AND REGULATIONS INVOLVED

The statutes involved are Sections 21(a), 22(a), 23(a)(1)(A), 41, 42(a), 43, and 48 (a) and (c), Internal Revenue Code of 1939; Sections 61, 63(a), 162(a), 441 (a) through (e), 446, 451(a), and 461(a), Internal Revenue Code of 1954. See Appendix, *infra*, pp. 1a–7a.

The Regulations involved are Treasury Regulations 118 (1939 Code), Sections 39.41–1, 39.41–2, 39.41–3, 39.41–4, 39.42–1(a), 39.42–4, 39.43–1(a), and 39.43–2; Treasury Regulations on Income Taxes (1954 Code), Sections 1.441–1, 1.446–1, 1.451–1(a), 1.451–3, and 1.461–1(a). See Appendix, *infra*, pp. 7a–30a.

STATEMENT

The material facts, as found by the Court of Claims (R. 51–54, 58–71), may be summarized as follows:

The taxpayer, a national automobile club having its principal office in Washington, D.C., was organized under the laws of Connecticut in 1910 as a non-stock,

membership corporation. In addition to services provided affiliated local automobile clubs and their members, the taxpayer directly operates ten local automobile clubs as divisions. (R. 58.)

A substantial portion of the taxpayer's annual gross income is derived from dues, paid one year in advance by members of the ten local automobile clubs. The taxpayer provides these members services which, although not completely uniform in every division, generally include: (a) a complete travel service including trip planning, tour books, accommodation directories, maps and recommended routes; (b) emergency road service (towing, changing tires, replacing batteries and other minor repairs), through contracts made with garages and service stations; (c) bail bond protection up to $5,000, through contracts made with bondsmen; (d) personal automobile accident insurance, through the purchase of group insurance policies; (e) a theft reward for information leading to the arrest and conviction of any person stealing a member's car. In addition, the taxpayer, in one or more of its divisions, provides other personal services such as procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts. (R. 58–59.)

Commencing with 1943, the taxpayer has been required to file federal income tax returns and to pay federal income taxes. The taxpayer employs an accrual method of accounting in keeping its books and filing its returns, and uses the calendar year as its

taxable year. (R. 59–60.) The method of accounting employed by the taxpayer during the years in issue has been used regularly by it since 1931 and is in accord with generally accepted commercial accounting principles. (R. 66.)

The dues received by the taxpayer from its members were deposited in the taxpayer's bank accounts, with no restrictions as to their use for any corporate purpose. (R. 63, 68.)

Under the method of accounting employed by the taxpayer during the years in issue, the dues received from members were not regarded entirely as income in the calendar year of receipt, but, instead, were treated as income received ratably over the twelve-month membership period even though such period extended beyond the close of the taxable year. As of December 31 of each taxable year, the percentage of dues collected within the taxable year, which the taxpayer considered applicable to memberships extending beyond the close of the year, was recorded as a liability of the taxpayer and was so reflected on the balance sheet accompanying its income tax return. Expenses which the taxpayer considered as prepaid membership costs were not deducted entirely in the taxable year paid or incurred, but were deducted ratably over the same period of time that dues were recognized as income. (R. 62.)

During the years from 1931 through 1953, dues collected in any month of the calendar year were included in income to the extent of one-twenty-fourth thereof in the month when the collections were made, one-twelfth in each of the succeeding eleven months,

and the remaining one-twenty-fourth in the last month, when the membership expired. The liability account which the taxpayer maintained on its books in order to reflect that portion of its monthly collections which were not included in income as of the close of the taxable year was entitled "Deferred Revenue Membership Dues", or some similar title. (R. 63–64.)

In 1954, in order to simplify its accounting system, the taxpayer changed its procedure by assigning 50 per cent of its annual collections to income for the current year and the remaining 50 per cent to the liability account, to be recognized as income in the following year. The taxpayer also revised its method of allocating some of its expenses. (R. 65.)

For the calendar years 1949 through 1954, the percentage of gross income from membership dues which taxpayer reported as income in the year of receipt, and the percentage deferred until the following taxable year, were as follows (R. 65):

	Portion recognized as income during the year collected	Portion remaining in the liability account Dec. 31 and treated as income the following year
1949	48.9%	51.1%
1950	50.0%	50.0%
1951	51.3%	48.8%
1952	52.0%	48.0%
1953	50.3%	49.7%
1954	50.0%	50.0%

The taxpayer's actual average cost per member in each month of the calendar years 1953 and 1954, and

the percentage of monthly costs to total costs for each month over the respective five-year periods preceding 1953 and 1954, were as follows (R. 71):

Month	1953			1954		
	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period
	Amount	Percent of cost for year		Amount	Percent of cost for year	
January	$1.12	7.71	7.46	$1.12	7.62	7.46
February	1.10	7.57	7.47	1.27	8.62	7.34
March	1.24	8.52	8.44	1.37	9.27	8.44
April	1.32	9.15	8.83	1.24	8.41	8.83
May	1.28	8.84	8.97	1.35	9.18	8.83
June	1.32	9.12	9.03	1.41	9.56	9.07
July	1.35	9.28	8.90	1.34	9.12	8.98
August	1.23	8.52	8.56	1.24	8.41	8.67
September	1.19	8.22	8.15	1.20	8.16	8.26
October	1.19	8.19	8.20	1.17	7.95	8.42
November	1.06	7.29	7.56	1.10	7.49	7.64
December	1.10	7.59	8.20	.91	6.21	8.11
Total	14.50	100.00	100.00	14.72	100.00	100.00

The following table (R. 69) shows the percentage of annual receipts from membership dues that would have been recognized as income in the year of receipt, and the remaining percentage that would have been deferred to the following year, had the taxpayer allocated its monthly receipts in proportion to its average monthly cost per member in each month of 1953 and 1954, or in proportion to average monthly costs over the respective five-year periods preceding 1953 and 1954, instead of allocating those receipts ratably over the membership period of twelve months:

	Plaintiff's pro rata method as reported	Average monthly costs for current year	Average monthly costs over prior 5-year period
1953			
Apportioned to gross income during current year	50.3%	49.8%	50.4%
Deferred to the following year (reported as a liability at the end of the current year)	49.7%	50.2%	49.6%
1954			
Apportioned to gross income during the current year	50.0%	48.8%	51.0%
Deferred to the following year (reported as a liability at the end of the current year)	50.0%	51.2%	49.0%

In its 1953 tax return, the amount of income reported by the taxpayer as attributable to dues receipts was $3,337,813.44, representing $1,562,042.23 of dues collected in 1952 but deferred as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year. In its return for 1954, the taxpayer reported dues income of $3,794,672.20, representing $1,755,407.46 of dues collected in 1953, but deferred as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year. (R. 66.)

Upon examination of the taxpayer's returns for 1952, 1953 and 1954, the Commissioner refused to recognize the deferral of income from one year to another for years subsequent to 1952, and also adjusted deductions taken for prepaid membership costs. The net effect of this determination was to increase the taxpayer's 1953 net income from $353,279.09 to $481,557.59 and to reduce its 1954 net operating loss from $289,967.67 to $14,412.49. As a consequence, a claimed net operating loss carryback from 1954 to 1952 was reduced, and a claimed net

operating loss carryback to 1953 was eliminated. These adjustments resulted in deficiencies in the amount of $58,083.58 for 1952 and $137,907.48 for 1953. The taxpayer paid these deficiencies, together with interest, and filed timely claims for refund, which were disallowed. (R. 60–62.) Taxpayer then sued for refund, and the Court of Claims sustained the Commissioner's determination.

SUMMARY OF ARGUMENT

The taxpayer's members paid annual membership dues in advance, and taxpayer received this income without restriction as to its use, depositing the funds in its general bank account. On its books, the taxpayer credited the dues received to a liability account designated "deferred revenue", as a reserve for estimated future expenses of performing services for its members, and monthly thereafter it transferred from this account one-twelfth of the amount of dues received to an "income" account. In filing its federal income tax returns on the calendar year and accrual basis, taxpayer reported as gross income only that portion of the dues collected which corresponded to the number of months falling within the taxable year (the amount reflected in the "income" account), and allocated the balance (the amount reflected in the "deferred revenue" account) to the following year.

I

The Court of Claims correctly sustained the Commissioner's determination that taxpayer was required to report as gross income the entire amount of mem-

bership dues received in the years received, without offset for estimated expenses anticipated in a later year (treated by taxpayer as "unearned" or "deferred" income). Under long established tax accounting principles embodied in the Internal Revenue Code, repeatedly reaffirmed by this Court and applied by the Tax Court and other courts, net taxable income (defined in the Code as gross income less allowable deductions for a given taxable year) must be computed and reported on an *annual* rather than on a *transactional* basis. *Security Mills Co.* v. *Commissioner*, 321 U.S. 281; *Brown* v. *Helvering*, 291 U.S. 193. This means that neither items of gross income nor items of deduction may be postponed or accelerated from one taxable year to another in order to reflect the income ultimately to be derived from a given transaction or group of transactions, irrespective of whether the taxpayer employs the cash or the accrual method of accounting. As applied to taxpayers using the accrual method, the annual accounting rule precludes the allocation of an item of gross income to any year other than that in which the right to receive it becomes fixed, which can be no later than the year in which it is actually received without restriction as to its use. *Security Mills Co.* v. *Commissioner, supra; Spring City Co.* v. *Commissioner*, 292 U.S. 182; *Commissioner* v. *Hansen*, 360 U.S. 446; *United States* v. *Lewis*, 340 U.S. 590. Conversely, an item of deduction (expense, loss, etc.) may be offset against gross income only in the year in which the liability to pay becomes fixed, *i.e.*, when all the events have occurred which determine both the fact and amount of the

liability. *Brown* v. *Helvering, supra; United States* v. *Anderson,* 269 U.S. 422; *Dixie Pine Co.* v. *Commissioner,* 320 U.S. 516.

The underlying purpose of the annual accounting system, as this Court has frequently pointed out, is to assure the government, through methods of accounting and collection capable of practical operation, an ascertainable amount of revenue at regular intervals. *E.g., Security Mills Co.* v. *Commissioner, supra; Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359. The only exceptions to the rule are those provided in the Internal Revenue Code itself and the Treasury Regulations, and, as observed in the concurring opinion below, neither the gross income nor the deductions with which we are here concerned come within any of the exceptions. This Court has properly refrained from carving out additional exceptions which Congress itself has not seen fit to enact. Moreover, the legislative history surrounding the enactment and repeal of Sections 452 and 462 of the Internal Revenue Code of 1954, dealing, respectively, with deferral of prepaid income and deductions of reserves for estimated expenses, as well as the history of recent attempts by particular classes of taxpayers (including membership corporations like the instant taxpayer) to obtain legislative exceptions in their favor, confirm the wisdom of leaving to Congress the creation of exceptions to the annual accounting rule.

During the taxable years here involved, the taxpayer not only had the right to receive annual dues from its members, but actually received them without restriction as to their disposition. The liability of

the taxpayer to render services to its members in exchange for the dues collected was entirely contingent upon the future needs and demands of its members. Moreover, a substantial portion of the expenses of performance was not actually incurred, *i.e.*, the liability to pay concededly did not become fixed, until a later taxable year. Nevertheless, in computing its annual taxable income, taxpayer allocated ("deferred") a percentage of its gross income from membership dues to a subsequent taxable year in order to reflect its contingent liability to perform future services. Its method of computation plainly violated established principles of tax accounting. The diminution of gross income by a reserve for contingent liabities, even though such liabilities stem from or are related to the transaction which produced the gross income, has been specifically disapproved by this Court. *Brown* v. *Helvering, supra.* For federal income tax purposes, and from a revenue standpoint, allocation of part of the gross income to a subsequent taxable year in order to reflect contingent liabilities accomplishes the same proscribed result.

Under a familiar corollary of the annual accounting rule—the so-called claim of right doctrine—a taxpayer who receives money under a claim of right and without restriction as to its use is required to report it as gross income in the year received, even though he is contingently obligated and is in fact required to refund the money in a later year. *E.g., United States* v. *Lewis,* 340 U.S. 590; *Healy* v. *Commissioner,* 345 U.S. 278. Since a contingent obligation to re-

store the very income received does not relieve the recipient taxpayer of a duty to report the income in the year of receipt, an obligation to perform future services in consideration of the income received does not suffice. Only when the expenses of performance are actually incurred—*i.e.*, only in the year when the liability to pay becomes fixed in fact and amount—will the taxpayer be entitled to offsetting deductions. *Security Mills Co.* v. *Commissioner, supra; Brown* v. *Helvering, supra.*

Nothing in the taxing statute or the controlling decisions supports taxpayer's contention that the federal income tax is imposed on "earned" income, whatever that elusive term may signify. The tax applies to the statutory "net income" ("gross income" less allowable "deductions") for a single "taxable year"—not to net income expected over the lifetime of the taxpayer or his business, nor to the overall long-term economic result of a particular contract or transaction, nor even (as the taxpayer here insists) to the net result of operations over a two-year period. The "transactional" approach urged by taxpayer—the "matching" and offsetting of future expenses against "related" current income—is the very antithesis of the annual accounting concept upon which the federal taxing system is erected, and has been expressly rejected by this Court. *Security Mills Co.* v. *Commissioner, supra.* See, also, *Guaranty Trust Co.* v. *Commissioner,* 303 U.S. 493, 498; *Heiner* v. *Mellon,* 304 U.S. 271, 275–276; *Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359, 364–365.

Whether taxpayer's method of accounting is in accord with commercial accounting practice is not controlling. Accounting practices designed to reflect net income in reports to stockholders or creditors are not necessarily suited to the requirements of a tax system. This Court has often held that accepted commercial accounting practices are not determinative of what is proper accounting for purposes of computing federal income tax liability. "Many reserves set up by prudent business men are not allowable as deductions". *Brown* v. *Helvering, supra,* p. 202. See, also, *Commissioner* v. *Hansen, supra; Weiss* v. *Wiener,* 279 U.S. 333, 335. The meaning accorded "net income" by the accounting profession differs significantly from the meaning of that term as used in the Internal Revenue Code and consistently applied by this Court.

II

The taxpayer mistakenly assumes that in *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, this Court, contrary to its repeated holdings in prior cases, sanctioned a departure from the fundamental annual accounting rule and related accrual principles. In *Michigan,* the Court sustained the Commissioner's rejection of a method of accounting virtually identical to that adopted by the taxpayer here. To be sure, in doing so it characterized that taxpayer's method of deferring income from prepaid dues as "artificial"; but, unless the decision is to be construed as a repudiation of all the Court's prior decisions on the subject (a con-

clusion which finds no support in the opinion), the artificiality of the method employed must be deemed a cumulative or independent reason for holding it impermissible for tax accounting purposes.

In addition, we point out that this taxpayer's method of accounting is no less "artificial" than that considered in *Michigan*. As taxpayer's own tabulation of past experience shows, the allocation formula adopted by it was an arbitrary one; the annual membership dues were apportioned in equal monthly amounts, whereas the alleged "related" expenses which it was called upon to incur varied substantially from month to month. That the allocation formula was purely artificial is further attested by the fact that, commencing in 1954, taxpayer changed the formula so as to treat 50 per cent of the dues received at any time during a current year as income accrued in the following year. In the circumstances, the Commissioner clearly did not abuse his discretion in rejecting the accounting method employed by taxpayer, and the court below properly sustained his determination on the authority of this Court's decision in the *Michigan* case.

ARGUMENT

INTRODUCTION

The taxpayer, an automobile club, receives a substantial part of its income from annual membership dues. In exchange, it contracts to provide during the year following receipt, upon a member's demand, various travel and road services. The dues collected from members are received without restriction as to

their use, are deposited in taxpayer's general bank account, and are used for any of its corporate purposes. On its books, however, the taxpayer treated a portion of the dues received as "deferred" income because of future services it might be called upon to render for its members, and in its federal income tax returns for each of the taxable years here involved it reported as gross income only the difference between the amount of dues received in that year and an estimated amount of future expenses it anticipated would be incurred in a later year in performing such services.[1]

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[1] Taxpayer set up on its books a "liability" account designated "deferred revenue", and an "income" account. The dues received were recorded in the "deferred revenue" account, and each month thereafter one-twelfth of the amount in that account was transferred to the "income" account. Only the amount reflected in the latter account was reported as gross income in its tax returns. (R. 63–64.)

The proportion of annual membership dues which taxpayer reflected in its "deferred" revenue account and excluded from the gross income reported in each taxable (calendar) year consisted not only of (1) a corresponding proportion of estimated annual expenses of performing services for its members, but also (2) a corresponding proportion of the excess of annual dues receipts over the estimated annual service expenses (which taxpayer treated as income "earned" in the taxable year from membership dues). To illustrate: if taxpayer received $120,000 of annual membership dues in November of the taxable year 1952, and anticipated incurring $90,000 of service expenses over the membership contract year, it treated two-twelfths ($20,000) of the receipts as "earned" in 1952 and excluded ten-twelfths ($100,000) from 1952 gross income; thus the $100,000 excluded represented not only ten-twelfths of the $90,000 estimated future expenses (or $75,000), but also ten-twelfths of the $30,000 anticipated "earnings" from 1952 membership contracts (or $25,000).

Broadly stated, the question here is whether a taxpayer filing its federal income tax returns on the calendar year-accrual basis may postpone reporting income received in a given taxable year merely because the income represents consideration for services to be performed (or goods to be delivered) in a later year and the taxpayer sets up on its books a contingent liability reserve (here designated a "deferred revenue" account) to reflect an estimated amount of expenses of future performance. The membership dues in question were received by taxpayer without restriction as to their use—the equivalent of economic ownership—and they admittedly constituted "gross income" as defined in Section 22(a) of the Internal Revenue Code of 1939 and comparable Section 61(a) of the 1954 Code (Appendix, *infra*, pp. 1a, 3a–4a). The issue thus is not *whether* the receipts were includible in gross income, but *when, i.e.*, in which taxable year they were includible. The problem may arise in either of two ways: (1) The taxpayer may accrue and report the entire amount received as gross income in the year of receipt, but seek to *deduct* a reserve for contingent liabilities representing the estimated expenses of future performance; or (2) it may seek (as does taxpayer here) to *exclude* from its gross income for the taxable year estimated expenses of future performance.[2]

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[2] See S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 62–63 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4694–4695), accompanying Sections 452 and 462 of the Internal Revenue Code of 1954, dealing respectively with "prepaid income" and "reserve for estimated expenses"; S. Rep. No. 372, 84th Cong., 1st Sess., p. 6 (1955-2 Cum. Bull. 858, 861), accompanying the

The taxpayer takes the position (Br. 9, 20–21) that its taxable income from membership dues should be computed on a transactional basis—by "matching" and offsetting against the dues collected in each taxable year an estimated amount of alleged "related" future expenses of performing services for its members, in order to arrive at "earned" income from membership contracts entered into in that year. It is the government's view that under long established principles of federal income tax accounting, repeatedly reaffirmed by this Court, (1) the taxpayer was required to accrue and report as gross income the entire amount of dues received, in the taxable year received; (2) it was entitled to deduct expenses of performing services for its members only in the year when the expenses were actually incurred; (3) it could neither exclude nor deduct from its gross income for any taxable year estimated amounts of future expenses it expected to incur.

In the argument which follows, we deal, first, with the tax accounting problem in its broad aspects (Point I). We set out in Point II our reasons for believing (a) that *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, did not sanction a departure from the annual accounting rule, and (b) that the essential features of the *Michigan* case,

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repeal of those sections by Sec. 1 of the Act of June 15, 1955, c. 143, 69 Stat. 134. The history of the enactment and repeal of Sections 452 and 462 of the 1954 Code, which sheds important light upon the congressional intent in enacting the accounting provisions of the Internal Revenue Code, is discussed *infra*, pp. 44–50.

which was decided in the Commissioner's favor, are not materially different from those presented here.[3]

I

TAXPAYER'S METHOD OF ACCOUNTING FOR ANNUAL MEMBERSHIP DUES RECEIVED, WHEREBY IT POSTPONED REPORTING A PORTION OF THE AMOUNT RECEIVED IN EACH TAXABLE YEAR UNTIL A SUBSEQUENT YEAR IN ORDER TO REFLECT ESTIMATED FUTURE EXPENSES OF PERFORMING SERVICES FOR ITS MEMBERS, VIOLATES SETTLED RULES OF INCOME TAX ACCOUNTING

A. TAXABLE NET INCOME (GROSS INCOME LESS ALLOWABLE DEDUCTIONS) MUST BE COMPUTED AND REPORTED ON AN ANNUAL, NOT A TRANSACTIONAL, BASIS

1. *The annual accounting requirement*

Sections 11 and 13 of the Internal Revenue Code of 1939 impose a tax on the "net income" of individuals and corporations, respectively.[4] Section 21 (Appendix, *infra*, p. 1a) defines "net income" as the "gross

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[3] A problem of accrual accounting is also involved in *United States* v. *Consolidated Edison Co. of New York*, now pending on certiorari, No. 357, this term. There, however, the question does not involve an effort by taxpayer to "match" income and estimated expenditures. The question in *Consolidated Edison* is, when does an item become sufficiently fixed for tax accounting purposes—specifically, whether a payment made in actual discharge of a liability may be deferred because the payor (an accrual basis taxpayer) continues to dispute the liability and is engaged in suing for a refund of the payment.

[4] Since the deficiencies in controversy are for the taxable years 1952 and 1953, and result in part from the disallowance of a claimed net operating loss carryback from 1954, the provisions of both the 1939 and 1954 Codes are applicable. The pertinent provisions of the two Codes, and of the implementing Treas-

income" less allowable "deductions"; Section 22(a) (Appendix, *infra*, p. 1a) defines gross income as including income derived from any source; and Section 23(a) (Appendix, *infra*, p. 1a) authorizes the deduction of ordinary and necessary business expenses, "paid or incurred during the taxable year". Sections 41, 42(a), and 43 (Appendix, *infra*, pp. 2a–3a) require net income to be computed on the basis of an "annual accounting period" (the "taxable year"), in accordance with the method of accounting regularly employed by the taxpayer, provided such method clearly reflects the net income for the taxable year. See also Section 48 (Appendix, *infra*, p. 3a); Sections 39.41–1, 39.41–2, 39.41–3, 39.41–4, 39.42–1, 39.42–4, 39.43–1, 39.43–2 of Regulations 118 under the 1939 Code (Appendix, *infra*, pp. 7a–15a).[8]

For federal income tax purposes, as the Court is aware, the two principal recognized accounting systems are the so-called "cash" and "accrual" methods. Under the "cash" method, gross income is reported in the year of actual receipt and deductions are taken

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nary Regulations under each, are substantially the same in all material respects. However, the provisions of the 1954 Code and Regulations thereunder are more explicit than those of the 1939 Code and Regulations. See Appendix, *infra*, pp. 1a–30a.

[8] The corresponding provisions of the 1954 Code (Sections 61, 63(a), 162(a), 441 (a) through (e), 446, 451(a), and 461(a)), and the corresponding provisions of the Regulations under the 1954 Code (Sections 1.441–1, 1.446–1, 1.451–1(a), 1.451–3, and 1.461–1(a)) are reproduced in the Appendix, *infra*, at pp. 3a–7a, 15a–30a.

in the year of actual expenditure. Under the "accrual" method, gross income items are reported in the year in which the right to receive them becomes fixed, even though they are not currently receivable, but no later than the year of actual receipt; conversely, deduction items are reported in the year in which they are incurred, *i.e.*, when the liability to pay becomes fixed in fact and amount, even though payment is not then due, but no later than the year of actual payment. Whichever method is adopted must of course be applied consistently. *Security Mills Co.* v. *Commissioner*, 321 U.S. 281; *Brown* v. *Helvering*, 291 U.S. 193; *Commissioner* v. *Hansen*, 360 U.S. 446; *Spring City Co.* v. *Commissioner*, 292 U.S. 182; *United States* v. *Anderson*, 269 U.S. 422; *Consolidated Edison Co. of New York* v. *United States*, 279 F. 2d 152 (C.A. 2d), certiorari granted, 364 U.S. 890.

The cardinal rule, embodied in Section 41 and often reiterated by this Court, is that the net income must be computed on an annual basis, whether the cash or the accrual method is selected. Neither income nor deduction items may be accelerated or postponed from one taxable year to another in order to reflect the long-term economic result of a particular transaction or group of transactions. *Security Mills Co.* v. *Commissioner*, *supra*; *Brown* v. *Helvering*, *supra*; *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359; *Guaranty Trust Co.* v. *Commissioner*, 303 U.S. 493; *Heiner* v. *Mellon*, 304 U.S. 271.*

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* Although 1939 Code Section 41 provides that the net income shall be computed "in accordance with the method of accounting regularly employed in keeping the [taxpayer's]

The annual accounting rule, and its underlying purpose, were summarized by this Court in the leading *Security Mills* case, *supra*. In that case, a taxpayer on the accrual basis included in its 1935 income processing taxes which it collected as part of the sales price of flour sold to its customers; subsequently, when the tax was held unconstitutional, it reimbursed its customers. In holding that the taxpayer could not deduct the later year's refunds as an offset against its 1935 income, the Court stated (pp. 286–287):

> The rationale of the system is this: "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practical to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation." [Quoting from *Burnet* v. *Sanford & Brooks*, 282 U.S. at 363.]
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> This legal principle has often been stated and applied. The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt

books", this requirement is qualified by the antecedent prescription that the computation be made "upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be)". Taxpayer's suggestion that its method of accounting must be accepted for tax computation purposes because it was "regularly" employed begs the issue; if adopted it would lead to the anomalous result that a taxpayer is relieved of the duty to reflect income on an annual basis simply by disregarding the annual accounting requirement over a number of years, before the Commissioner has audited its returns and challenged its method of accounting.

> or payment, *or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.*
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> But the petitioner urges that § 43 has altered the rule so that a hybrid system, partly annual and partly transactional, may, within administrative discretion, be substituted for that of annual accounting periods. * * * The very section on which petitioner relies, however, reiterates the adherence of Congress to the system of annual periods of computation. [Emphasis added.]

In *Lewyt Corp* v. *Commissioner,* 349 U.S. 237, the Court again stated (p. 242) that "the concept 'accrued' embodies the annual accounting principle". See, also, *Dixie Pine Co.* v. *Commissioner,* 320 U.S. 516. Moreover, in a case involving a taxpayer engaged in the same kind of income-producing activities as the taxpayer here, and using virtually the identical method of accounting, this Court has sustained the Commissioner's disapproval of the taxpayer's accounting method. *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180. See discussion, *infra,* pp. 54–57.

In harmony with this Court's decisions, the lower courts, in a variety of contexts, have insisted upon compliance with the annual accounting rule. See, *e.g., Spencer, White & Prentis* v. *Commissioner,* 144 F. 2d 45 (C.A. 2d), certiorari denied, 323 U.S. 780; *Streight Radio and Television, Inc.* v. *Commissioner,* 280 F. 2d 883 (C.A. 7th), pending on taxpayer's petition for certiorari (No. 507, this Term); *Capital*

Warehouse Co. v. *Commissioner*, 171 F. 2d 395 (C.A. 8th); *South Dade Farms* v. *Commissioner*, 138 F. 2d 818 (C.A. 5th); *Clay Sewer Pipe Ass'n* v. *Commissioner*, 139 F. 2d 130 (C.A. 3d); *New Capital Hotel* v. *Commissioner*, 261 F. 2d 437 (C.A. 6th), affirming per curiam, 28 T.C. 706. And in a case similar in all material aspects to this one, the Tax Court has likewise insisted upon adherence to the rule. *Automobile Club of New York* v. *Commissioner*, 32 T.C. 906, pending on appeal (C.A. 2d). See, also, *New Jersey Automobile Club* v. *United States*, 181 F. Supp. 259 (C. Cls.), petition for certiorari pending (No. 140, this Term); *Automobile Club of Southern California* v. *United States* (S.D. Cal., decided February 11, 1960, 5 A.F.T.R. 2d 901), pending on appeal (C.A. 9th).'

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[1] In the *Automobile Club of New York* case, *supra*, the Tax Court stated, in part (32 T.C., pp. 911–913):

"This Court has consistently held that the Commissioner has authority to require that prepaid income be reported no later than the year in which it is received, provided such income is subject to unrestricted use by the taxpayer. This rule applies to taxpayers on an accrual basis as well as to those on the cash basis; it applies even though the income may in a sense be regarded as "earned" in a year subsequent to the year of receipt, and even though some systems of accounting in the business world may recognize deferral in such circumstances. * * *

"On an accrual basis of accounting, items of income and deduction may 'accrue' even prior to actual receipt or payment; income is treated as received when the right thereto becomes fixed and deductions are allowable when the liability in respect thereof is unqualifiedly determined. As a practical matter, the income tax laws must operate on an annual basis, and there is no assurance under either an accrual or cash basis of accounting that there will be complete correlation between items of income and deductions pertinent thereto in any given

2. *The transactional method urged by taxpayer*

The taxpayer's method of accounting, on its face, fails to satisfy the annual accounting requirement and related accrual concepts. Instead of accruing and reporting as gross income in each taxable year the entire amount of dues received in that year, and deducting only expenses actually incurred in the same year, it excluded ("deferred") from its gross income an estimated amount of expenses it expected to incur in the succeeding year. Its deferral from the year of receipt to the following year of a portion of its gross income (dues receipts), in order to reflect a reserve for contingent liabilities (estimated amount of future expenses), cannot be squared with this Court's injunction in *Security Mills* (321 U.S. at 286–287) against "allocating income or outgo to a year other than the year * * * in which the right to receive, or the obligation to pay, has become final and definite in amount." Far from reflecting its net income for a single "taxable year" on the basis of gross income actually accrued and liabilities actually incurred within that year, as demanded by the statute and this Court's

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taxable year or that income will always be taxed in the year 'earned'. * * *

"* * * It has not been the practice in tax accounting to enter upon a further inquiry as to whether the income has been "earned" in order to defer the reporting of such income to a later year. The practical difficulties in embarking upon such inquiry and the burden of making the necessary allocations of the amounts of income which, though realized in the taxable year, would have to be charged in part to the taxable year and in part to other years, make clear why no such system has ever been part of the general scheme of our tax laws. * * *"

decisions, taxpayer's returns purported to reflect the net result of its transactions over a period of two taxable years.

In support of its method of accounting, taxpayer contends (Br. 10–11, 19–20) that the federal income tax is imposed upon "earned" income, which it vaguely defines as income remaining after "matching" and deducting "related" future expenses. In substance, taxpayer seeks to cut across its annual accounting periods and employ a "hybrid system, partly annual and partly transactional"—a system which, this Court held in *Security Mills* (p. 287), finds no place in the statutory scheme for computing federal income tax liability.[8] Indeed, the transactional theory advocated

[8] The term "earnings" has never been used in the income tax statutes to describe either the object of the tax or its method of computation. Under the Internal Revenue Code of 1939 the corporate income tax is imposed on the "normal-tax net income", as defined in Section 13, and the "surtax net income" as defined in Section 15. The term "net income" itself is defined in Section 21 as "the gross income computed under section 22, less the deductions allowed by section 23". Section 41 provides that the taxpayer's computation of "The net income" must clearly reflect "the income". The statutory scheme in the 1954 Code is basically the same, except that the term "taxable income" has been substituted for "net income". See Sections 11, 62, 63, 161–175, 241–247, 441, and 446, Internal Revenue Code of 1954. Compare the use of the term "earnings and profits" in Section 115 of the 1939 Code (Section 316 of the 1954 Code), relating to dividend distributions. As the Tax Court observed in *Streight Radio and Television, Inc.* v. *Commissioner*, 33 T.C. 127, 138, affirmed, 280 F. 2d 883 (C.A. 7th):

"Tax accounting does not concern itself with the fine question of whether items have been "earned" in the accounting sense, * * * and this is true whether the item in question has been received, or is merely a receivable."

by taxpayer "proves too much, for under it a taxpayer on the accrual basis could estimate the entire gross income which might be received from his contract [here, membership contracts], though no work had been begun, could deduct the estimated expense of performance and could compute the taxes accordingly". *Spencer, White & Prentis* v. *Commissioner*, 144 F. 2d 45, 46 (C.A. 2d), certiorari denied, 323 U.S. 780. The situation here is essentially no different from any other in which a taxpayer on the accrual basis receives income in one taxable year, out of which expenses or losses will have to be paid in a later year. Under long settled tax accounting principles, the tax on the income in the year of receipt may not be withheld or diminished by excluding or deducting from the gross income a reserve to cover an estimated amount of anticipated expenses or losses.

Basically the same transactional or "earnings" approach advocated by this taxpayer has been rejected by this Court in numerous cases besides *Security Mills* (*e.g.*, *Brown* v. *Helvering*, *supra*; *Burnet* v. *Sanford & Brooks Co.*, *supra*; *Guaranty Trust Co.* v. *Commissioner*, *supra*; *Heiner* v. *Mellon*, *supra*), and by the lower courts (*e.g.*, *Spencer, White & Prentis* v. *Commissioner*, *supra*; *Streight Radio and Television, Inc.* v. *Commissioner*, *supra*; *Capital Warehouse Co.* v. *Commissioner*, *supra*; *Clay Sewer Pipe Ass'n* v. *Commissioner*, *supra*; *South Dade Farms* v. *Commissioner*, *supra*).*

* The Second Circuit's decision in *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520, typical of the lower courts decisions upon which taxpayer relies, appears irreconcilable with

Thus in *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, it was held that compensatory damages received by the taxpayer in 1920 constituted gross income for the taxable year in which received, even though related to expenses incurred and deducted in prior years. In disposing of the taxpayer's argument that the gain or profit subject to tax could be ascertained "only * * * on the basis of particular transactions * * * when they are brought to a conclusion", this Court stated (pp. 364–365):

> Only by including these items of gross income in the 1920 return would it have been possible to ascertain respondent's net income for the period covered by the return, which is what the statute taxes. The excess of gross income over

its own decision in the *Spencer, White* case (see also *Commissioner* v. *Fifth Avenue Coach Lines*, 281 F. 2d 556 (C.A. 2d), petition for certiorari pending, No. 634, this Term), and was not followed by the Seventh Circuit in *Streight Radio*, which presented the same issue. But cf. *Milwaukee & Suburban Transport Corp.* v. *Commissioner*, 283 F. 2d 279 (C.A. 7th). We respectfully submit that neither the accounting provisions of the Code nor the controlling decisions of this Court warrant the novel distinction drawn in *Bressner* between "earned" and "unearned" items of gross income for tax accounting purposes. By attempting to "match" gross income received under an executory contract with "related" future expenses of performing the contract, the court in effect applied the proscribed transactional, rather than the prescribed annual, accounting system.

In Rev. Rul 60–85, 1960–1 Cum. Bull. 181, the Internal Revenue Service announced that it would not follow the *Bressner* decision, stating:

"The *Bressner Radio, Inc.*, decision conflicts in principle with a long line of judicial authority holding that where a taxpayer receives prepaid income under a claim of right and without restriction as to its disposition, it must report the entire amount received each year as income. * * *"

> deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the later period.
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> A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

The "earnings" approach for which taxpayer contends was again rejected in *Guaranty Trust Co.* v. *Commissioner,* 303 U.S. 493, 498:

> It is true that the acts of Congress taxing income have consistently laid the tax upon the net income received by or accrued to the taxpayer in a "taxable year," which is either the calendar year or a different fiscal year, as the taxpayer may elect. But they have never undertaken to limit the income taxable in any one year to that derived from the taxpayer's activities occurring in that or any other single year. *The items of gross income and of allowed deductions to be included in the income return, are those of the taxpayer for his taxable year, even though they may have resulted from or be*

> *affected by his business transactions of other years. Burnet* v. *Sanford & Brooks Co., supra,* 364, 365. *Circumstances wholly fortuitous may determine the year in which income, whenever earned, is taxable, and may thus affect the amount of tax. Receipt of income or accrual of the right to receive it within the tax year is the test of taxability, not the time it has taken the taxpayer to earn it* * * *. [Emphasis added.]

In *Heiner* v. *Mellon,* 304 U.S. 271, the business of two corporations was taken over by two partnerships formed for the purpose of liquidation. The primary question for decision was whether sales profits realized by the two partnerships in 1920 were taxable in that year. The Court said (pp. 275–276):

> Nor is it of legal significance that the liquidation was not completed until 1925 and that until completion of the liquidation it could not be known whether the business venture, taken as a whole, had been profitable. The federal income tax system is based on an annual accounting. Under that law the question whether taxable profits have been made is determined annually by the result of the operations of the year.
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> * * * * *
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> The fact that it might prove that when the business was fully liquidated the profits of 1920 were offset by heavy loss of later years is immaterial. *Losses suffered by a taxpayer in a later year may be deducted from profits, if any, earned by him in that later year; but the tax on a year's income may not be with-*

held because losses may thereafter occur. * * *
[Emphasis added.]

In *Brown* v. *Helvering,* 291 U.S. 193, the Court held that a taxpayer filing his returns on the accrual basis was not entitled to deduct from gross income (insurance commissions) received in the taxable year an amount which his experience for the preceding five years indicated would have to be refunded on account of policy cancellations, since his liability to repay was contingent, not fixed and absolute in that year. The Court stated (pp. 199, 201):

> Under the Revenue Acts taxable income is computed for annual periods. If the accounts are kept on the accrual basis the income is to be accounted for in the year in which it is realized even if not then actually received; and the deductions are to be taken in the year in which the deductible items are incurred. * * *
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> * * * * *
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> The liability * * * arising from expected future cancellations was not deductible from gross income because it was not fixed and absolute. In respect to no particular policy written within the year could it be known that it would be cancelled in the future year. Nor could it be known that a definite percentage of all the policies will be cancelled in the future years. Experience taught that there is a strong probability that many of the policies written during the taxable year will be so cancelled. But experience taught also that we are not dealing here with certainties. This is shown by the variations in the percentages in the several five-year periods of the aggregate of refunds to the aggregate of overriding commissions.

The taxpayer is here attempting to accomplish what this Court in *Brown* held was not permissible—to offset against gross income for the taxable year an estimated amount of future liabilities based upon taxpayer's experience and attributable to contracts entered into in the taxable year. While this taxpayer seeks to exclude ("defer") an estimated amount from current gross income, instead of deducting it from gross income (as in *Brown*), the net result, from the tax standpoint, is the same under either method. See *Streight Radio and Television, Inc.* v. *Commissioner, supra; South Dade Farms* v. *Commissioner, supra; Automobile Club of New York* v. *Commissioner, supra.*[10]

United States v. *Anderson*, 269 U.S. 422, upon which taxpayer relies (Br. 25), does not support its position. The Court there sustained the Commissioner's determination that a tax imposed on profits from munitions manufactured in 1916 should have been deducted from gross income in that year, even though it was not due and payable until 1917, because (pp. 440–441) "all the events" had occurred in 1916 to "fix the amount of the tax and determine the liability of the taxpayer to pay it".[11] As was pointed out by

[10] See also H. Rep. No. 293, 84th Cong., 1st Sess., p. 4 (1955–2 Cum. Bull. 852, 854), accompanying the repeal of Sections 452 and 462 of the Internal Revenue Code of 1954, discussed *infra*, pp. 48–50.

[11] The Court also approved T.D. 2433, 19 Treasury Decisions, Internal Revenue 5 (1917), as a correct interpretation of Section 13(d), Revenue Act of 1916, c. 463, 39 Stat. 756. In that section, Congress for the first time provided that a return might be made in accordance with a taxpayer's books of account. T.D. 2433 limited the accrual of reserves for tax pur-

the Second Circuit in *Spencer, White & Prentis* v. *Commissioner, supra* (p. 47):

> The petitioner's reliance upon *United States* v. *Anderson*, 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347, is misplaced. There the deduction of certain estimated tax liabilities set up in a reserve entered on the taxpayer's books in accordance with a Treasury Regulation was allowed, though the taxes had not been assessed. But all the events had occurred which determined the liability to pay the tax. Here liability for the work done after * * * [the taxable year] had not been incurred for the work had not been performed. * * *[11a]

The transactional or "earnings" theory of tax accounting urged by taxpayer ignores the rationale of the annual accounting rule, to say nothing of the rule itself. As pointed out in *Sanford & Brooks, supra,* and again in *Security Mills,* the annual accounting system is rooted in strong practical and policy considerations—the need of the United States for an ascertainable amount of revenue at regular intervals,

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poses to reserves for liabilities actually "incurred" during the taxable year; reserves for contingent liabilities were expressly disapproved. It further provided that "in cases wherein deductions are made on the accrual basis as hereinbefore indicated income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis".

[11a] Note, also, that in *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516, which stressed the applicability of the annual accounting rule to taxpayers reporting on the accrual basis, this Court cited its *Anderson* decision for the following proposition (p. 519): "It has long been held that in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid".

collectible through a system capable of practical operation.

By requiring an accrual basis taxpayer to report gross income when the right to receive it becomes fixed, and to deduct liabilities when all the events have occurred which fix both the fact and amount of the liability, the annual accounting system permits the taxpayer to compute, and the Commissioner to assess, the tax on the basis of facts rather than estimates. Moreover, these standards apply uniformly to accrual basis taxpayers in all types of business situations. The transactional or earnings approach, on the other hand, would place on the Commissioner the enormous burden of evaluating and verifying complex statistical evidence submitted by millions of taxpayers in an endless variety of business contexts to prove that they have reliably "related" and "matched" present income with estimated future expenses, or present expenses with estimated future income.[12] Revenue agents will not only become involved in technical accounting problems in order to determine the validity and accuracy of the taxpayer's estimates in the first instance, but will be obliged to re-audit the taxpayer's accounts in later years to ascertain whether subsequent business experience corresponds with the taxpayer's previous estimates. And in cases where there is a variance between prior estimates and subsequent experience, adjustments of the resultant understate-

[12] See Schapiro, *Tax Accounting for Prepaid Income and Reserves for Future Expenses*, Tax Revision Compendium, submitted to the Committee on Ways and Means (1959), Vol. 2, pp. 1133, 1142–1145.

ment or overstatement of actual "earnings" in earlier years, as well as adjustments of the taxpayer's current estimates to assure that past errors will not be perpetuated, will become necessary. Moreover, by offsetting against current income estimated future expenses, the taxpayer may effectively postpone the collection of tax until a later period without any guarantee that tax rates will be the same or that he will later be able to pay the tax."[13]

Adoption of the transactional or "earnings" approach would also pose difficult problems for the courts. It would invite litigation as to whether particular items of income and expense are sufficiently "related" to justify their being "matched", either by a deferral of income or the accrual of a reserve for estimated expenses; and, even if there is a discernible relationship between such items, as to whether the tabulations and ratios submitted by the taxpayer, or those prepared by revenue agents, more accurately

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[13] While the instant case involves an attempt to employ a transactional method of accounting in order to "defer" to the next taxable year a portion of prepaid income (dues) received under one-year membership contracts, the difficulties inherent in applying such a method would of course be magnified in cases where, for example, the taxpayer chooses to sell 5-year or even lifetime membership contracts, or in cases involving prepaid compensation, royalties, rent, etc. covering several years or indefinite periods. Moreover, if taxpayer's transactional accounting theory were adopted, the "deferred" portion of the prepaid income received in such cases would not only be increased, but the taxable year to which such portion would be allocated would be postponed beyond the succeeding year and far into the future. Cf. *Schlude* v. *Commissioner*, 283 F. 2d 234 (C.A. 8th), petition for certiorari pending, No. 629, this Term.

reflect that relationship. The courts would thus inevitably become embroiled in accounting controversies far more numerous, complex, and time-consuming than those they are now called upon to decide under the annual accounting rule.

3. *The claim-of-right doctrine*

It is settled, as a familiar corollary of the annual accounting rule, that a taxpayer (whether on the cash or accrual basis) who receives income under a claim of right and without restriction as to its use must report it in the year received, even though he may later be required to restore the income. *North American Oil* v. *Burnet,* 286 U.S. 417; *United States* v. *Lewis,* 340 U.S. 590; *Healy* v. *Commissioner,* 345 U.S. 278. See also *Rutkin* v. *United States,* 343 U.S. 130.[14]

We agree with taxpayer (Br. 27–30) that the so-called claim of right doctrine is not directly applicable here, since the income in question—membership dues—admittedly belonged to taxpayer and there was never any dispute as to its right to receive or keep the income. See dissenting opinion of Mr. Justice

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[14] As was stated in *United States* v. *Lewis,* 340 U.S. at 592:

"Income taxes must be paid on income received (or accrued) during an annual accounting period. Cf. I.R.C., §§ 41, 42; and see *Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359, 363. The 'claim of right' interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, Law of Federal Income Taxation, § 12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer."

Harlan in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. at 191–192. However, we submit that the doctrine and its rationale lend strong support to the government's position. Since the annual accounting rule requires a taxpayer who receives *disputed* income under a claim of right and without restriction as to its use to report it in the year received, notwithstanding that he may later be required to *refund* the very income received, it would seem to follow that a taxpayer must report *undisputed* income in the year received even though he may later be required to *use* some or all of it to meet alleged "related" expenses. See *Streight Radio and Television, Inc.* v. *Commissioner, supra; Spencer, White & Prentis* v. *Commissioner, supra; South Dade Farms* v. *Commissioner, supra; Capital Warehouse Co.* v. *Commissioner, supra; Clay Sewer Pipe Ass'n* v. *Commissioner, supra.* In the case of a taxpayer who is required to repay income received in a previous taxable year, the amount repaid is deductible only in the year in which the liability to repay becomes fixed. *United States* v. *Lewis, supra.* Similarly, in the case of a taxpayer who is required to incur expenses attributable to or in consideration of income received in a prior year, the expenses are deductible only in the year in which the liability to pay them becomes fixed. *Security Mills, supra; Brown* v. *Helvering, supra; United States* v. *Anderson, supra; Dixie Pine Co.* v. *Commissioner, supra.*

4. *Commercial accounting practices*

There is no warrant for taxpayer's assumption (Br. 16–22) that the annual accounting rule and related

accrual concepts laid down by this Court in federal income tax cases must yield to commercial (non-tax) accounting principles. It has often been emphasized that generally accepted commercial accounting practices are not controlling for purposes of computing federal income tax liability. *Brown* v. *Helvering, supra; Security Mills, supra; Lucas* v. *American Code Co.*, 280 U.S. 445; *Bazley* v. *Commissioner*, 331 U.S. 737, 741; *Commissioner* v. *Hansen*, 360 U.S. 446. Even accounting methods prescribed by federal regulatory agencies to insure compliance with other federal statutes are not determinative of tax liability under the Revenue Acts. *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 562; *Mine Hill & Schuylkill Haven R. Co.* v. *Smith*, 184 F. 2d 422 (C.A. 3d), certiorari denied, 340 U.S. 932; *Kansas City Southern Ry. Co.* v. *Commissioner*, 52 F. 2d 372, 378 (C.A. 8th), certiorari denied, 284 U.S. 676. What constitutes a fair and accurate statement of a taxpayer's income in a report to creditors or stockholders, or even for purposes of complying with some other statute, does not necessarily coincide with what must be reported as income under the taxing statute; each report is designed to serve discrete needs and objectives.

Thus, in *Commissioner* v. *Hansen*, 360 U.S. 446, this Court recently held that an automobile dealer was not entitled to exclude from its gross income a "dealer's reserve", representing a portion of the sales price withheld by finance companies, even though it was the "common pattern" (p. 448) and "consistent practice" (p. 452) in the trade to treat such reserves as unac-

crued and unearned until paid over to the dealer. "Many reserves set up by prudent business men are not allowable as deductions". *Brown* v. *Helvering, supra,* 291 U.S. at 202. As the Court stated in *Weiss* v. *Wiener,* 279 U.S. 333, 335: "The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer. * * *"

It is noteworthy that for general business purposes the accounting profession has ascribed a meaning to "net income" which differs significantly from the meaning of that term as used in the Internal Revenue Code and consistently applied by this Court. The term has been defined by the American Institute of Accountants as synonymous with "earnings" over a "period of years", and as having reference, moreover, to "the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period".[15] Such a transactional or "earnings" method of accounting, although it may serve useful business purposes, is com-

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[15] The American Institute of Accountants, in its Accounting Terminology Bulletin No. 2, pp. 3–4 (March, 1955), defines "net income" as follows:

"The terms *net income* or *net profit* refer to the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period.

* * * * *

"The term earnings is not used uniformly but it is generally employed as a synonym for 'net income,' particularly over a period of years. * * *"

pletely at odds with the annual accounting rule which (as this Court has many times held) is the cornerstone of the federal income tax system. Furthermore, the transactional method of arriving at "net income", approved by the accounting profession for commercial accounting purposes, entails allocations of "charges and credits" which are "estimated" and are "based on assumptions as to future events which may be invalidated by experience"[16]—an approach opposed to the principle that, for federal income tax accounting purposes, a liability may not be accrued and deducted from gross income unless and until it becomes fixed both in fact and amount. *Security Mills, supra; Brown* v. *Helvering, supra; United States* v. *Anderson, supra; Dixie Pine Co.* v. *Commissioner, supra.* As was acknowledged by Professor Paton, the taxpayer's principal witness, there is considerable difference of opinion within the accounting profession itself as to the standards to be applied, even for commercial accounting purposes, in determining what items of expense or other contingent liabilities should be attributed to and offset against cur-

[16] As stated by the American Institute of Accountants in its Accounting Research Bulletin No. 43, p. 59 (1953):

"Allocations to fiscal periods of both charges and credits affecting the determination of net income are, in part, estimated and conventional and based on assumptions as to future events which may be invalidated by experience. While the items of which this is true are usually few in relation to the total number of transactions, they sometimes are large in relation to the other amounts in the income statement."

rent revenue in order to reflect "earned" income." See, also, Schapiro, *Tax Accounting for Prepaid Income and Reserves for Future Expenses;* Tax Revision Compendium, submitted to the Committee on Ways and Means (1959), Vol. 2, pp. 1133, 1142–1143; Recommendations to Congress by the American Institute of Accountants regarding *Divergencies Between Rules of Tax Accounting and Generally Accepted Accounting Principles,* 97 Journal of Accountacy 93 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 62–63, quoted at footnote 23, pp. 46–47, *infra.*

The taxpayer stresses (Br. 16, 31) the provision in Section 39.41–2(a) of Regulations 118 under the 1939 Code that "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income." This is hardly an unqualified approval of all commercial accounting practices. Moreover, the corresponding Regulations under the 1954 Code, which elaborate those promulgated under the 1939 Code and also incorporate judicially approved tax accounting principles, carefully explain that the accounting method used by the taxpayer will be acceptable only "if it accords with generally recognized and accepted *income tax accounting principles* and is consistently used by the taxpayer from year to year." Regula-

[17] For example, Professor Paton stated (R. 47) that "in the field of determining the cost assigned to the volume of sales or services rendered, we do have a lot of difficult accounting questions". He also testified (R. 45) that whereas the measure of revenue at the top of an income statement is "a relatively simple thing," the "determination of the costs that are properly applicable to that revenue is a much more controversial subject".

tions § 1.446–1(c) to (ii), Appendix, *infra*, pp. 19a–20a. (Emphasis added.) [18]

Furthermore, Rev. Rul. 60–85, 1960–1 Cum. Bull. 181–182, which is addressed to the very problem here presented, specifically provides that:

> where a taxpayer receives prepaid income under a claim of right and without restriction as to its disposition, it must report the entire amount received each year as income. * * *
>
> Accordingly, the Service will continue its general policy of taxing prepaid income in the year of receipt. This policy applies to income from contracts to furnish services and to other types of prepaid income, such as prepaid royalties, rent, bonuses, etc., regardless of whether the period of proration is definite or indefinite, unless a different treatment is specifically provided in the Internal Revenue Code of 1939 or 1954 or the regulations thereunder.

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[18] This portion of the Regulations under the 1954 Code provides, in part, as follows:

"(ii) *Accrual method.* Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. * * *"

B. CONGRESS HAS AUTHORITATIVELY REJECTED THE METHOD OF ACCOUNTING WHICH TAXPAYER URGES UPON THE COURT

1. *Statutory exceptions to the annual accounting rule*

Before turning to the specific history which shows that Congress has rejected the approach urged by taxpayer—has, indeed, rejected it in the same context in which the matter is presented here—we point out that Congress has long been aware of the rigid requirements of the annual accounting rule and that it has made explicit statutory exceptions in those instances in which it has deemed relief appropriate.[19] Among the special provisions which it has enacted are the following: Section 44 of the Internal Revenue Code of 1939, and Section 453 of the Internal Revenue Code of 1954 (installment sales); Section 122 of the Internal Revenue Code of 1939, and Section 172 of the Internal Revenue Code of 1954 (net operating loss deduction); Section 23(k) of the Internal Revenue Code of 1939, and Section 166 of the Internal Revenue Code of 1954 (bad debt reserves); Sections 201(c)(2) and 202 of the Internal Revenue Code of 1939 (credit for estimated liability reserves of life insurance companies); Sections 802, 803(b) and 804(a), Internal Revenue Code of 1954 (deduction for estimated liability reserves of life insurance companies); Sections 204(b) (6) and (7), (c) (1) and (4), Internal Revenue Code of 1939, and Sections 832(b) (5) and (6), (c) (1) and (4), Internal Revenue Code of 1954 (definitions of "losses incurred" and "expenses incurred"

[19] See the comment in the concurring opinion below, R. 57–58.

with respect to deductions allowed insurance companies other than life and mutual); Section 461(c), Internal Revenue Code of 1954 (proration of real property taxes related to a definite period of time); Section 171, Internal Revenue Code of 1954 (amortizable bond premium); Sections 1301–1307, Internal Revenue Code of 1954 (long-term compensation).[20] See, also, the exception expressly authorized in the long-standing Treasury Regulations with respect to long-term contracts. *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 366; Regulations 118, Section 39.42–4 (App., *infra*, pp. 12a–13a); Regulations under the Internal Revenue Code of 1954, Section 1.451–3 (App., *infra*, pp. 26a–28a).

Of the above provisions, Section 122 of the 1939 Code (1954 Code Section 172) provides an apt and familiar illustration. The provisions of that section authorize, with certain limitations, the carry-back or carry-over of net operating losses. (We note parenthetically that taxpayer rests upon this section (see R. 53–54) in seeking to carry back to 1952 and 1953 a claimed net operating loss for 1954.) As this Court commented in *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382, 386: "Those provisions were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like

[20] An additional exception, relating to income deferral by publishers, is discussed *infra*, p. 52.

an average taxable income computed over a period longer than one year."[21]

The taxpayer in the instant case is attempting to go far beyond the net operating loss carry-back exception to the annual accounting rule. It simultaneously seeks to exclude from its gross income for the earlier year a reserve for future expenses. As we point out immediately below, an exception of this kind was authorized by Congress for a brief period and then disapproved.

2. *The enactment and repeal of 1954 Code Sections 452 and 462*

Sections 452 and 462 of the Internal Revenue Code of 1954 were designed to authorize, with specified limitations, essentially the same kind of transactional method of accounting which the taxpayer now asks

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[21] A "net loss" carry-back or carry-over provision appeared for the first time in Section 204 of the Revenue Act of 1918, c. 18, 40 Stat. 1057. Its express purpose was to relieve taxpayers from the harshness of the annual accounting system. As stated in the Committee Report (S. Rep. No. 617, 65th Cong., 3d Sess., p. 7) (1939–1 Cum. Bull. (Part 2) 117, 121–122):

"One of the most important provisions inserted by the committee is quite new to our tax laws. At the present time no recognition is given to net losses; that is, if in any year the losses and expenses of a taxpayer exceed his gross income the excess (or in other words, the net loss) can not be carried over into the next year. *For purposes of taxation the settlement must be made upon the basis of each year's business by itself.* The chief merit of the present plan is its simplicity of administration. But it does not adequately recognize the exigencies of business, and, under our present high rates of taxation, may often result in grave injustice. * * * (Emphasis added.)

this Court to sanction. The provisions of those sections and the Committee Reports accompanying their enactment unmistakably show a Congressional understanding that no such method was permissible under existing law, and the repeal of those sections, shortly after enactment, shows no less clearly a purpose to revert to preexisting tax accounting rules.

As enacted in 1954, Section 452 provided that an accrual basis taxpayer might defer "prepaid income" over a maximum period of six years beginning with the "taxable year in which such income is received". Significantly, it was provided, for purposes of identifying the year of receipt, that "prepaid income" would be "treated as received during the taxable year for which it is includible in gross income under Section 451 (without regard to this section)", *i.e.*, as receivable in the year in which the *whole sum* would have been returnable if Section 452 had not been enacted.[22] Thus, Congress must have regarded Section 451, considered by itself, as precluding taxpayers, whatever their method of accounting, from reporting income any later than the year in which actually received. This is the only construction of Section 451 that is consistent with the language of Section 452 in general and Section 452(e)(3) in particular. So viewed, Section 452 was not intended as declaratory of existing law, but rather as alleviating the rigors of the annual accounting principle embodied in the general accounting provisions of the Code.

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[22] 1954 Code Section 451 is the successor to 1939 Code Section 42 (Appendix, *infra*, p. 7a).

Similarly, Section 462 provided that an accrual basis taxpayer might deduct "a reasonable addition to each reserve for estimated expenses to which this section applies", but the term "estimated expense" was defined in subsection (d)(1) as a "deduction * * * part or all of which would (but for this section) be required to be taken into account for a subsequent taxable year * * *." Thus, it was Congress' view in 1954 (when it revised the entire Code) that "but for" the relief afforded by Section 462, an accrual basis taxpayer could not, under the accounting provisions of the Code, deduct a reserve for estimated expenses. The Senate Finance Committee Report accompanying Sections 452 and 462 (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 301 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4940) stated:

> Under the 1939 Code, regardless of the method of accounting, with minor exceptions established by regulations or administrative practice, amounts are includible in gross income by the recipient not later than the time of receipt if they are subject to free and unrestricted use by the taxpayer even though the payments are for goods and services to be provided by the taxpayer at a future time. * * *[23]

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[23] The Report further stated (pp. 62–63) (3 U.S.C. Cong. & Adm. News (1954) 4621, 4694–4695)):

"Under present law payments received in advance for the use of property in future years or for services to be rendered in future years are includible in the income of the recipient in the year they are received. This is true regardless of the taxpayer's method of accounting. However, well-established accounting procedure provides that in the case of those on an accrual accounting system payments for rentals, club dues,

The privileges conferred by Sections 452 and 462 were limited in various ways in order to guard against undue loss of revenue and possible abuses by taxpayers seeking to take advantage of the new provisions. Thus, Section 452 established a maximum of six years over which income might be deferred. In addition, provisions were inserted to deal with situations where the liability (with respect to which income could be deferred) was of "indefinite" duration, or extended beyond the six-year period, or terminated prior to the inclusion in gross income of amounts previously deferred. Similarly, Section 462 provided for adjustments of "excessive" reserves.

These limitations, however, proved inadequate. In 1955, the Treasury recognized that it was encountering a myriad of enforcement problems, with taxpayers

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warehouse fees, and the like should be included in income in the year in which the income is earned and in the year in which the related expenses are incurred. This is not necessarily the year of receipt.

"The House and your committee's bill permit accrual-basis taxpayers to defer the reporting of advance payments as income until the year, or years, in which, under the taxpayer's regular method of accounting, the income is earned. * * *

* * * * *

"Under present law deductions for expenses and losses incurred by a taxpayer may be taken only when all events have occurred which fix the fact and the amount of the taxpayer's liability. This, in many cases, is at variance with generally accepted accounting principles which require all determinable liabilities relating to reported income to be taken into account.

"The House and your committee's bill conform the tax treatment of expenses more closely to general business treatment by permitting an accrual-basis taxpayer to deduct reasonable additions to reserves for estimated expenses. * * *"

over-estimating future expenses and threatening litigation as to the extent of the deferral and reserves permitted. House Hearings, Ways and Means Committee, Prepaid Income and Reserves for Estimated Expenses, on H.R. 4725, 84th Cong., 1st Sess., pp. 1, 3–4, 6, 10–11, 32, 34–35. As a consequence of these practical difficulties, and the anticipation of ensuing revenue losses far in excess of those contemplated at the time of enactment,[24] Sections 452 and 462 were repealed by the Act of June 15, 1955, c. 143, 69 Stat. 134, Section 1. The Committees of both Houses indicated that the subject was to be studied further with a view to the "early" enactment of "definite" legislative rules dealing with income deferral and the accrual of estimated reserves. S. Rep. No. 372, 84th Cong., 1st Sess., p. 6 (1955–2 Cum. Bull. 858, 861); H. Rep. No. 293, 84th Cong., 1st Sess., p. 4 (1955–2 Cum. Bull. 852, 854).

At the time that repeal of Sections 452 and 462 was being considered, the American Automobile Association (taxpayer in the case at bar) appeared at the Congressional hearings and suggested that Section 452 ("PREPAID INCOME") be retained even if Section 462 ("RESERVES FOR ESTIMATED EXPENSES") were repealed. House Hearings, Prepaid Income and Reserves for

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[24] As stated in H. Rep. No. 293, 84th Cong., 1st Sess., p. 3 (1955–2 Cum. Bull. 852, 854):

"Last year when these provisions were enacted it was estimated by the Treasury Department that the total revenue loss involved in all of the accounting provisions was $47 million. From incomplete information now available it appears that the loss from these two provisions alone may well exceed $1 billion. Your committee believes that this is a loss which the Nation can ill afford at this time."

Estimated Expenses, on H.R. 4725, 84th Cong., 1st Sess., pp. 173–176. This proposal was expressly rejected by Congress for the reason that taxpayers could accomplish the same result under Section 452 by deferring income, as they could under Section 462 by deducting estimated expenses.[25] As stated in the report of the House Ways and Means Committee, accompanying repeal (H. Rep. No. 293, 84th Cong., 1st Sess., p. 4 (1955-2 Cum. Bull. 852, 854–855):

> Proposals have been advanced that the income-deferring provisions of section 452 should be retained in the law even though the estimated expense provisions of section 462 are repealed. It is contended that the revenue loss from section 452 is relatively insignificant in relation to the loss involved in section 462. * * * It has been advised by the Treasury, however, that if section 452 is not repealed at the same time section 462 is repealed, a number of taxpayers who have reported a greatly reduced tax liability by electing the benefits of section 462 would be able to accomplish the same result by electing to defer income under section 452. For example, under section 462 it is possible to set up a reserve for estimated expenses attributable to fulfilling obligations of servicing and repairs under a product guaranty. If section 462 only

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[25] Representatives of the television service industry also appeared at these hearings, urging the retention of Section 452, so as to permit the deferral of income with respect to television service contracts extending beyond the close of the taxable year. House Hearings, Prepaid Income and Reserves for Estimated Expenses, on H.R. 4725, 84th Cong., 1st Sess., pp. 140–143, 266–267.

were repealed, it would be possible for taxpayers, simply by changing the form of the transaction, to defer under section 452 that portion of income from the sale of the product which is attributable to the liability for future servicing and repairs under the guaranty. It is, therefore, deemed necessary to repeal section 452 as well as section 462.

In connection with the repeal of 1954 Code Sections 452 and 462, the Treasury confirmed the understanding of the House Ways and Means Committee that the repeal would "operate simply to reestablish the principles of law which would have been applicable if sections 452 and 462 had never been enacted." Letter from Secretary of the Treasury Humphrey to Chairman Cooper, March 22, 1955, reproduced in H. Rep. No. 293, *supra*, p. 5 (1955–2 Cum. Bull., p. 855).

3. *Subsequent unsuccessful attempts to obtain legislative approval of taxpayer's method of accounting*

The taxpayer has sought, on four separate occasions, legislation which would sanction the transactional method of accounting for which it here seeks judicial approval. Congress has not seen fit to grant its approval.

The first unsuccessful attempt occurred in 1955 when, as previously noted, taxpayer proposed that Congress retain Section 452 permitting "deferral" of income, even though it repealed Section 462 permitting the accrual of estimated reserves.

Another effort was made in 1956 by the introduction of H.R. 10833, 84th Cong., 2d Sess., which would have permitted "deferral" with respect to three classes of income—specifically, "prepaid" newspaper and periodical subscriptions, "prepaid" rent, and "prepaid" dues and fees received from members by "nonprofit service organizations." The bill was referred to the Committee on Ways and Means but was never reported out, Congress having in the meantime adjourned. Thereafter, at hearings held in November, 1956, the representatives of the American Automobile Association appeared and made the following recommendation (Hearings before a Subcommittee of the House Ways and Means Committee, Technical Amendments to the Internal Revenue Code, 84th Cong., 2d Sess., p. 308): [26]

> 1. We join the American Institute of Accountants, and the other witnesses who have appeared before you, in recommending to this subcommittee the prompt reenactment of section 452 of the Internal Revenue Code of 1954 on a modified basis.
>
> 2. The new section 452 should be specific, rather than general, in order that you will know what items are covered and in order that you can estimate the income involved, insofar as the scope of its application is concerned; and should apply at least to prepaid rents, prepaid subscription income, and prepaid dues and fees received from members by organizations whose

[26] Similar recommendations were made by the representative of the National Committee on Federal Taxation. See House Hearings, *supra*, p. 414.

> principal activity is providing services to its members.

In 1958, Congress enacted Section 455 of the Internal Revenue Code of 1954,[27] permitting the deferral of "prepaid subscription income"—a provision which settled the issue of income deferral with respect to publishers. See *Beacon Publishing Co.* v. *Commissioner,* 218 F. 2d 697 (C.A. 10th), reversing 21 T.C. 610; *Automobile Club of Michigan* v. *Commissioner,* 353 U.S., p. 189, fn. 20. During the course of the Senate debate on this exception, a proposed subsection (f) was offered in order to provide that the same treatment being accorded publishers be extended so as to cover automobile clubs receiving prepaid dues. In conference, however, the House refused to accept the amendment, and the Senate conferees abandoned it. H. Conference Rep. No. 2632, 85th Cong., 2d Sess., p. 25 (1958–3 Cum. Bull. 1188, 1212). Senator Byrd explained the rejection of the amendment, as follows (104 Cong. Record, Part 14, p. 17744):

> It was the position of the House conferees that this matter of prepaid dues and fees received by non-profit service organizations was a part of the entire subject dealing with the treatment of prepaid income and that such subject should be left for further study of this entire problem. * * *

Finally, as recently as 1960, a similar bill (H.R. 11266, 86th Cong., 2d Sess.), permitting the deferral

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[27] Sec. 28, Technical Amendments Act of 1958, P.L. 85–866, 72 Stat. 1606, 1625.

of "Prepaid Dues Income of Certain Membership Organizations", actually passed the House (on August 24, 1960, 106 Cong. Rec. (Daily Ed.) 16256), but Congress adjourned on September 1, 1960, without taking further action on the measure.

In short, the legislative history and experience surrounding the enactment and repeal of 1954 Code Sections 452 and 462 (dealing with the treatment of prepaid income and reserves for estimated expenses by accrual-basis taxpayers in general), coupled with the history of the several unsuccessful attempts to procure on behalf of automobile clubs special legislative approval of a transactional method of accounting, emphasize the wisdom of leaving to Congress the creation of any exceptions to the established annual accounting rule, and the nature of the limitations and safeguards which should be attached to any such exception in order to protect the revenues. Congress having expressly declined to sanction the transactional method of accounting here urged by taxpayer, both as to accrual-basis taxpayers in general and as to automobile clubs in particular, the court below properly refused to do so. As the Seventh Circuit stated in affirming the Tax Court's decision in a case involving substantially the same issue here presented (*Streight Radio and Television, Inc.* v. *Commissioner,* 280 F. 2d 883, 888, pending on petition for certiorari, No. 507, this Term), "If, instead of a system of annual accounting, a basis of finally ascertained results of particular transactions is to be substituted, Congress and not the courts must provide it."

II

EVEN ASSUMING THAT TAXABLE INCOME MAY BE COMPUTED AND REPORTED ON A TRANSACTIONAL RATHER THAN ON AN ANNUAL BASIS, THE TAXPAYER'S TRANSACTIONAL METHOD OF ACCOUNTING WAS PROPERLY REJECTED BY THE COURT BELOW ON THE AUTHORITY OF *AUTOMOBILE CLUB OF MICHIGAN* v. *COMMISSIONER*, 353 U.S. 180

In *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, this Court sustained the discretionary action of the Commissioner in disallowing a method of accounting virtually identical to that employed by the taxpayer in this case. There, as here, the taxpayer-automobile club (an affiliate of the present taxpayer) allocated an estimated percentage of its gross income from membership dues to the taxable year following the year of receipt, in order to reflect service liabilities which were contingent, both in fact and in amount, upon the future needs and demands of the club's members. This feature led the Court t hold (p. 189) that the taxpayer's method of allocation was "purely artificial" and bore "no relation to the services which petitioner may in fact be called upon to render for the member". As the court below pointed out, the same factor is present in this case, and renders the *Michigan* case controlling.[28]

[28] The Tax Court in *Automobile Club of New York* v. *Commissioner*, 32 T.C. 906, 912, 913; pending on appeal (C.A. 2d), and the District Court in *Automobile Club of Southern California* v. *United States* (S.D. Calif.), decided February 11, 1960 (5 A.F.T.R. 2d 901), pending on appeal (C.A. 9th), have also interpreted *Automobile Club of Michigan* as a rejection by this Court of the method of accounting advanced by the

If, as we contend (Point I, *supra*), taxable net income must be computed and reported on an annual basis, then, of course, *any* transactional method of accounting whereby the taxpayer seeks to exclude or deduct from a current year's income a reserve for estimated future expenses or losses—whether or not such method is otherwise "artificial"—derogates from the annual accounting rule and related accrual concepts, and must for that reason be rejected. And since taxpayer avowedly computed and reported its taxable income on a transactional rather than on an annual basis—by attempting to "match" estimated expenses of performing services for its members in a subsequent year against "related" income from dues received in the taxable year (Br. 10–11, 19–20)—there is no need for any further inquiry as to whether, as taxpayer claims (Br. 39–41), its particular transactional method differed substantially from that considered in *Michigan*.

Because this Court, in *Michigan*, sustained the Commissioner's disapproval of a transactional method of accounting on the ground that it was "purely artificial", the taxpayer assumes that the Court tacitly endorsed the use of transactional accounting methods which are *not* artificial. We submit, however, that the *Michigan* decision was not intended, nor may it properly be viewed, as a repudiation by this Court of all of its prior decisions upholding the annual as

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taxpayer. See, also, *New Jersey Automobile Club* v. *United States*, 181 F. Supp. 259 (C. Cls.), petition for certiorari pending (No. 140, this Term).

opposed to the transactional system of accounting. (See Point I, *supra*.) At most it can be said that the accounting issue in the case (one of several issues presented) went on an independent ground. That the Court did not intend to depart from the fundamental annual accounting rule, and thereby open the door to transactional methods of accounting, is indicated by its reference (pp. 188–189) to the so-called claim-of-right doctrine, a familiar corollary of the annual accounting rule. (See Point I, A, 3, *supra*.)

In any event, as the court below pointed out (R. 56), the method of accounting which the taxpayer employed was "essentially the same method" as was condemned by this Court in *Michigan* (p. 189) as "purely artificial". Accordingly, quite apart from the fact that the method violated the annual accounting rule, it must, on the authority of this Court's *Michigan* decision, likewise be rejected for that reason. Taxpayer's argument on this score (Br. 41–46) points to nothing which in any material respect serves to differentiate its method of accounting from that considered in *Michigan*. It used substantially the same internal bookkeeping system of "deferring" portions of annual membership dues received, and, like the taxpayer in *Michigan*, it admittedly reported as gross income for tax purposes only a portion of the dues received in each taxable year (calendar year), the portion reported being based upon the number of months in the membership-contract year which had elapsed by the close of the taxable year.

Indeed, the very tabulations which taxpayer introduced in evidence demonstrate that its *pro rata* method of allocating each year's membership dues in equal monthly amounts was not in fact "related" to the monthly expenses which it later incurred. The amount of those expenses varied considerably from month to month. During 1953, the average monthly cost per member ranged from a low of $1.06 in November to a high of $1.35 in July—a variation of more than 27 per cent. In 1954, the average monthly cost per member ranged from a low of $0.91 in December to a high of $1.41 in June—a variation of nearly 65 per cent. (R. 70–71.) [29] That the monthly *pro rata* allocation formula used by taxpayer was artificial is accentuated by the fact (R. 53, 65) that, commencing in 1954, taxpayer changed the formula so as to treat half of the dues received as income for the year of receipt, and the other half as income for the following year. Thus, even if we assume for purposes of argument that taxable net income may be computed by matching "related" items of income and expense, without regard to the limitations of the annual accounting rule, it is nevertheless clear that the method of accounting which the taxpayer employed did not accomplish that objective.

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[29] The taxpayer's witness, Arthur I. Cooper, pointed out (Supp. R. 28) that "If income had been recorded in proportion to expenses, * * * we would have reflected an income in 1954 * * * approximately $30,000" more than was actually reflected on the taxpayer's books.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment of the Court of Claims is correct and should be affirmed.

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FEBRUARY 1961.

APPENDIX

Internal Revenue Code of 1939:

SEC. 21. NET INCOME.

(a) *Definition.*—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

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(26 U.S.C. 1952 ed., Sec. 21.)

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal

services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be propery accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U.S.C. 1952 ed., Sec. 43.)

SEC. 48. DEFINITIONS.

When used in this chapter—

(a) *Taxable Year.*—"Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. * * *

* * * * *

(c) *"Paid or Incurred", "Paid or Accrued."*—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * * * *

(26 U.S.C. 1952 ed., Sec. 48.)

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

(b) *Cross References.*—

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

(26 U.S.C. 1958 ed., Sec. 61.)

SEC. 63. TAXABLE INCOME DEFINED.

(a) *General Rule.*—Except as provided in subsection (b), for purposes of this subtitle the term "taxable income" means gross income, minus the deductions allowed by this chapter, other than the standard deduction allowed by part IV (sec. 141 and following).

* * * * *

(26 U.S.C. 1958 ed., Sec. 63.)

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

* * * * *

(26 U.S.C. 1958 ed., Sec. 162.)

SEC. 441. PERIOD FOR COMPUTATION OF TAXABLE INCOME.

* *

(a) *Computation of Taxable Income.*—Taxable income shall be computed on the basis of the taxpayer's taxable year.

(b) *Taxable Year.*—For purposes of this subtitle, the term "taxable year" means—

(1) the taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(2) the calendar year, if subsection (g) applies; or

(3) the period for which the return is made, if a return is made for a period of less than 12 months.

(c) *Annual Accounting Period.*—For purposes of this subtitle, the term "annual accounting period" means the annual period on

the basis of which the taxpayer regularly computes his income in keeping his books.

(d) *Calendar Year.*—For purposes of this subtitle, the term "calendar year" means a period of 12 months ending on December 31.

(e) *Fiscal Year.*—For purposes of this subtitle, the term "fiscal year" means a period of 12 months ending on the last day of any month other than December. In the case of any taxpayer who has made the election provided by subsection (f), the term means the annual period (varying from 52 to 53 weeks) so elected.

* * * * *

(26 U.S.C. 1958 ed., Sec. 441.)

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) *Permissible Methods.*—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) *Taxpayer Engaged In More Than One Business.*—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

(26 U.S.C. 1958 ed., Sec. 446.)

SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) *General Rule.*—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

* * * * *

(26 U.S.C. 1958 ed., Sec. 451.)

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) *General Rule.*—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

* * * * *

(26 U.S.C. 1958 ed., Sec. 461.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39.41–1 *Computation of net income.* Net income must be computed with respect to

a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42–1 to 39.42–3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

SEC. 39.41–2 *Bases of computation and changes in accounting methods.* (a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in

any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§ 39.42–2 and 39.42–3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 39.22(c)–5.)

(b) The true income, computed under the Internal Revenue Code, and if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

(c) A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§ 39.22(c)–1 to

39.22(c)–8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see § 39.42–4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see §§ 39.22 (a)–7 and 39.23(a)–11. Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. See section 22(d) and §§ 39.22(d)–1 to 39.22(d)–7, inclusive, with respect to changing to the last-in first-out method of inventorying goods.

(d) Section 44 contains special provisions for reporting the profit derived from the sale of property on the installment plan.

(e) The foregoing requirements relative to a change of accounting method are not applicable if a taxpayer desires to adopt the installment basis of returning income, as provided in §§ 39.44–1 and 39.44–3, but are applicable if a taxpayer desires to change from such basis to a straight accrual basis. In cases where permission to make such change is granted, the taxpayer will be required to return as additional income for the taxable year in which the change is made all the profit not thereto-

fore returned as income pertaining to the payments due on installment sales contracts as of the close of the preceding taxable year.

SEC. 39.41–3. *Methods of accounting.* It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 54 and § 39.54–1.) Among the essentials are the following:

(a) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see section 22(c) and §§ 39.22(c)–1 to 39.22(c)–8, inclusive);

(b) Expenditures made during the year should be properly classified as between capital and expense; that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

(c) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses.

SEC. 39.41–4 *Accounting period.* The return of a taxpayer is made and his income computed for his taxable year, which in gen-

eral means his fiscal year, or the calendar year if he has not established a fiscal year. (See section 48.) The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December. No fiscal year will, however, be recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith. A person having no such fiscal year must make his return on the basis of the calendar year. Except in the case of a first return for income tax a taxpayer shall make his return on the basis upon which he made his return for the taxable year immediately preceding unless, with the approval of the Commissioner, he has changed his accounting period. See § 39.46–1.

SEC. 39.42–1 *When included in gross income—(a) In general.* Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. See §§ 39.41–1 to 39.41–3, inclusive. * * *

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SEC. 39.42–4 *Long-term contracts.* (a) Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section, the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such

contracts may, as to such income, prepare their returns upon either of the following bases:

(1) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

(2) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

(b) A taxpayer may change his method of accounting to accord with subparagraph (1) and (2) of paragraph (a) of this section only after permission is secured from the Commissioner as provided in § 39.41–2.

SEC. 39.43–1 *"Paid or incurred" and "paid or accrued."* (a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided

in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

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SEC. 39.43–2 *When charges deductible.* Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and de-

duction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. * * *

Treasury Regulations on Income Taxes (1954 Code):

§ 1.441–1 PERIOD FOR COMPUTATION OF TAXABLE INCOME.—(a) *Computation of taxable income.*—Taxable income shall be computed and a return shall be made for a period known as the "taxable year." For rules relating to methods of accounting, the taxable year for which items of gross income are included and deductions are taken, inventories, and adjustments, see sections 446 to 482, inclusive, and the regulations thereunder.

(b) *Taxable year.*—(1) the Term "taxable year" means—

(i) The taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(ii) The calendar year, if section 441(g) (relating to taxpayers who keep no books or have no accounting period) applies; or

(iii) The period for which the return is made, if the return is made under section 443 for a period of less than 12 months, referred to as a "short period."

(2) A taxable year may not cover a period of more than 12 calendar months except in the case of a 52–53-week taxable year. See § 1.441–2.

(3) A new taxpayer in his first return may adopt any taxable year which meets the requirements of section 441 and this section without obtaining prior approval. The first taxable year of a new taxpayer must be adopted on or before the time prescribed by law (not including ex-

tensions) for the filing of the return for such taxable year. However, for rules applicable to the adoption of a taxable year by a partnership, see § 1.442–1(b)(2), section 706(b), and § 1.706–1(b). For rules applicable to the taxable year of a member of an affiliated group which makes a consolidated return, see § 1.1502–14 and § 1.442–1(d).

(4) After a taxpayer has adopted a calendar or a fiscal year, he must use it in computing his taxable income and making his returns for all subsequent years unless prior approval is obtained from the Commissioner to make a change or unless a change is otherwise permitted under the internal revenue laws or regulations. See section 442 and § 1.442–1. For rules applicable to changes in taxable years of partners and partnerships, see also section 706(b) and § 1.706–1(b).

(c) *Annual accounting period.*—The term "annual accounting period" means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes his income in keeping his books.

(d) *Calendar year.*—The term "calendar year" means a period of 12 months ending on December 31. A taxpayer who has not established a fiscal year must make his return on the basis of a calendar year.

(e) *Fiscal year.*—(1) The term "fiscal year" means—

(i) A period of 12 months ending on the last day of any month other than December, or

(ii) The 52–53-week annual accounting period, if such period has been elected by the taxpayer.

(2) A fiscal year will be recognized only if it is established as the annual accounting period of the taxpayer and only if the books of the

taxpayer are kept in accordance with such fiscal year.

* * * * * * *

(g) *No books kept; no accounting period.*—

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Records which are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books.

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SEC. 1.446–1 GENERAL RULE FOR METHODS OF ACCOUNTING.—(a) *General rule.*—(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

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(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return as, for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on

hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see sections 471 and 472, and the regulations thereunder.)

(ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

(iii) In any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, or depletion, any expenditures (other than ordinary repairs) made to restore the asset or prolong its useful life shall be added to the asset account or charged against the appropriate reserve.

(b) *Exceptions.*—(1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(2) A taxpayer whose sole source of income is wages need not keep formal books in order to have an accounting method. Tax returns, copies thereof, or other records may be sufficient to establish the use of the method of accounting used in the preparation of the taxpayer's income tax returns.

(c) *Permissible methods.*—(1) *In general.*—Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method.*—Generally, under the cash receipts and

disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451–2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and § 1.461–1 (a)(1).

(ii) *Accrual method.*—Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. Likewise, the extent to which indirect costs shall be included in computing cost of goods sold depends upon the method used by the taxpayer in treating such items in keeping his books.

(iii) *Other permissible methods.*—Special methods of accounting are described elsewhere in chapter 1 of the Internal Revenue Code and the regulations thereunder. For example, see the following sections and the regulations thereunder; Sections 61 and 162, relating to the crop method of accounting; section 453, relating to the installment method; section 451, relating to the long-term contract methods. In addition, special methods of accounting for particular items of income and expense are provided under other sections of chapter 1. For example, see section 174, relating to research and experimental expenditures, and section 175, relating to soil and water conservation expenditures.

(iv) *Combinations of the foregoing methods.*—(*a*) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

(*b*) A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

(2) *Special rules.*—(i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

(ii) No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the Income Tax Regulations if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the Income Tax Regulations, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. See section 446(a) and paragraph (a) of this section, which require that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books, and section 446(e) and paragraph (e) of this section, which require the prior approval of the Commissioner in the case of changes in accounting method.

(d) *Taxpayer engaged in more than one business.*—(1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used

for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

(e) *Requirement respecting the adoption or change of accounting method.*—(1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this

section. See also section 446(a) and paragraph (a) of this section.

(2) (i) Except as otherwise expressly provided in chapter 1 of the Internal Revenue Code of 1954 and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured, whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxapayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

(ii) Examples of changes requiring consent are: A change from the cash receipts and disbursements method to an accrual method, or vice versa; a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder); a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451–3); a change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income, such as the crop method; or a change in the treatment of any other items of income or expense, where material.

(3) In order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application by letter with the Commissioner of Internal Revenue, Washington 25, D.C., within 90 days after the beginning of the taxable year in which it is desired to make the change. The application shall be accompanied by a statement

specifying the nature of the taxpayer's business, his present method of accounting, the method to which he desires to change, the taxable year in which the change is to be effected, the classes of items which would be treated differently under the new method, and all amounts which would be duplicated or omitted as a result of the proposed change. The Commissioner may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions and adjustments under which the change will be effected. See section 481 and regulations thereunder, relating to certain adjustments required by such changes, section 472 and the regulations thereunder, relating to changes to and from the last-in, first-out method of inventorying goods, and section 453 and the regulations thereunder, relating to certain adjustments required by a change from an accrual method to the installment method.

SEC. 1.451-1 GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.—(a) *General rule.*—Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income

for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in the prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and § 1.706–1(a). If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

* * * * *

SEC. 1.451–3 LONG-TERM CONTRACTS.—(a) *Definition.*—The term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted.

(b) *Methods.*—Income from long-term contracts (as defined in paragraph (a) of this section), determined in a manner consistent with the nature and terms of the contract, may be included in gross income in accordance with one of the following methods, provided such method clearly reflects income:

(1) *Percentage of completion method.*—Gross income derived from long-term contracts may be reported according to the percentage of completion method. Under this method, the portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year shall be included in gross income for such taxable year. There shall then be deducted all expenditures made during the taxable year in connection with the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable year for use in such contract. Certificates of architects or engineers showing the percentage of completion of each contract during the taxable year shall be available at the principal place of business of the taxpayer for inspection in connection with an examination of the income tax return.

(2) *Completed contract method.*—Gross income derived from long-term contracts may be reported for the taxable year in which the contract is finally completed and accepted. Under this method, there shall be deducted from gross income for such year all expenses which are properly allocable to the contract, taking into account any material and supplies charged to the contract but remaining on hand at the time of completion.

(c) *In general.*—Long-term contract methods of accounting apply only to the accounting for income and expenses attributable to long-term contracts. Other income and expense items, such as investment income or expenses not at-

tributable to such contracts, shall be accounted for under a proper method of accounting. See section 446(c) and § 1.446–1(c). A taxpayer may change to or from a long-term contract method of accounting only with the consent of the Commissioner. See section 446(e) and § 1.446–1(e). When a taxpayer reports income under a long-term contract method, a statement to that effect shall be attached to his income tax return.

* * * * *

SEC. 1.461–1 GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.—(a) *General rule.*—(1) *Taxpayer using cash receipts and disbursements method.*—Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) *Taxpayer using an accrual method.*—Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

(3) *Other factors which determine when deductions may be taken.*—(i) Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year cannot be used to reduce the income of a subsequent year. A taxpayer may not take advantage in a return for a subsequent year of his failure to claim deductions in a prior taxable year in which such deductions should have been properly taken under his

method of accounting. If a taxpayer ascertains that a deduction should have been claimed in a prior taxable year, he should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account.

(ii) Where there is a dispute and the entire liability is contested, judgments on account of damages for patent infringement, personal injuries or other causes, or other binding adjudications, including decisions of referees and boards of review under workmen's compensation laws, are deductions from gross income when the claim is finally adjudicated or is paid, depending upon the taxpayer's method of accounting. However, see subparagraph (2) of this paragraph.

(iii) For special rules relating to certain deductions, see the following sections and the regulations thereunder: Section 1481, relating to accounting for amounts repaid in connection with renegotiation of a government contract; section 1341, relating to the computation of tax where the taxpayer repays a substantial amount received under a claim of right in a prior taxable year; and section 165(e), relating to losses resulting from theft.

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No. 288

IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

AMERICAN AUTOMOBILE ASSOCIATION, *Petitioner*

v.

UNITED STATES

On Writ of Certiorari to the United States Court of Claims

REPLY BRIEF FOR PETITIONER

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From the original statement of the question in issue[1] throughout most of its brief, respondent fails to face squarely the issue involved in this proceeding, an issue which has not been decided previously on the merits by

[1] Brief for Respondent, p. 2.

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[1] Brief for Respondent, p. 2.

this Court.[2] The real problem is "how to compute income" under principles of accrual accounting where prepaid receipts are involved.

Respondent, on page 16 of its brief, attempts an identification of the problem in the following language:

> "Broadly stated, the question here is whether a taxpayer filing its federal income tax returns on the calendar year-accrual basis may postpone reporting *income* received in a given taxable year merely because the *income* represents consideration for services to be performed (or goods to be delivered) in a later year . . . ." (Italics supplied.)

In order to state the issue clearly, we must substitute for the italicized word "income", the correct words "prepaid receipts" or "prepaid dues", and we must add that deferral is made in order to match prepaid receipts with related revenue in the same taxable periods in order to reflect income clearly. The issue is not whether prepaid dues are includible in gross income, but when, i.e., in which taxable year—under accrual accounting, not cash accounting.

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[2] "Thus, the issue of the inclusion of prepaid income, *properly allocated* to future periods, in current taxable income was not passed upon by the Supreme Court" in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957). Behren, "Prepaid Income—Accounting Concepts and the Tax Law," 15 Tax L. Rev. 313, 360 (1960).

In *Brechner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520, 526 (2d Cir. 1959), the United States Court of Appeals for the Second Circuit, in commenting on the *Michigan* case, observed:

"It is apparent from the decision of the majority that at least for purposes of the decision of the case it assumed that a realistic deferral would have been permissible, and found only that no realistic deferral was made."

In its brief respondent does not contend that petitioner's method of accounting for prepaid dues fails to conform with generally accepted principles of accrual accounting or that it fails to reflect its income clearly. The findings of fact of the Court of Claims and of the Commissioner of the Court of Claims who heard the testimony preclude such an argument.[3] To cover up this omission, respondent seeks to beg the question or to obscure it by the simple expedient of labeling prepaid dues as "income" when received, despite the fact that accrual and not cash accounting is in issue. Alternatively, respondent seeks to mislead the Court into believing that the issue involves the deductibility of a "contingent liability reserve",[4] or the deductibility of "estimated amounts of future expenses it [petitioner] expected to incur,"[5] neither of which, obviously, was the issue litigated in the Court below, and neither of which is the issue before this Court.

Respondent, in its brief,[6] discusses the problem of computing taxable income as though the Internal Revenue Code contained one list of items which are denominated "gross income" and another list of items which constitute "allowable deductions", and that "taxable income" during any annual period is computed by subtracting the latter from the former. While this approach has at least the merit of simplicity and could have some application to a cash basis taxpayer,

[3] Court of Claims' Finding 22, R. 66, and Finding 31, R. 70; Commissioner's Finding 22, R. 18, 19, Finding 33, R. 26.

[4] Brief for Respondent, p. 2.

[5] Brief for Respondent, p. 17.

[6] Brief for Respondent, pp. 17-18.

it ignores completely the provisions of the Code which refer to, authorize and approve the use of accrual accounting for federal income tax purposes.

The accrual method of accounting is expressly authorized by Section 446 of the 1954 Code, Section 41 of the 1939 Code and comparable provisions of every Revenue Act since 1916. And a basic principle of accrual accounting is that advances from members or customers, i.e., prepaid receipts, do not constitute revenue or income until such time as services are rendered or made available (or goods are delivered).

Not only is this a cardinal principle of accrual accounting which should be acceptable for tax purposes, since accrual accounting itself is acceptable, but accounting for prepaid receipts as taxable income in a taxable period different from the year of receipt is expressly authorized by a statutory provision entitled "General Rule for Taxable Year of Inclusion" of an item of gross income. Section 451 of the 1954 Code (as did Section 42(a) of the 1939 Code) provides:

> "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.*" (Italics supplied.)

As a result of the application of this principle to this case, membership dues prepaid for twelve months in advance must not, in the case of an accrual basis taxpayer, be includible in taxable income for a taxable period except to the extent that the obligation to the members expires within such period. Respondent's brief fails to discuss the meaning and significance of

the above quoted statute which has a material, if not conclusive, bearing upon the disposition of this case.

In reading respondent's brief one would never suspect that the regulations of the Commissioner of Internal Revenue shed substantial light on the issue. The fact is that the Commissioner's own regulations both under the 1939 Code[7] and the 1954 Code unequivocally support petitioner's position.

Pertinent quotations from the Commissioner's Regulations interpreting the accounting provisions of the 1954 Code are as follows:

> "It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. . . . A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income. . . ."[8]
>
> "Generally, under an accrual method, income is to be included for the taxable year when all of the events have occurred which fix the right to receive such income and the amount thereof can be deter-

[7] Treas. Reg. 118, sec. 39.41-1 (1953) provide in part:

"The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the *fundamental rule* that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for . . ." (Italics supplied.)

[8] Treas. Reg., sec. 1.446-1(a)(2) (1957).

> mined with reasonable accuracy. . . . The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year."[9]

The confusion generated by respondent's brief is compounded by its numerous quotations from decisions of this Court which are alleged to constitute authority for the proposition that the annual accounting requirement prevents an accrual basis taxpayer from accounting for prepaid receipts as income later than the year of receipt. There are, of course, no such decisions of this Court. Respondent neglects to call attention to the fact that many of the decisions from which it quotes do not even involve accrual basis taxpayers, but refer to cash basis taxpayers.[10] Most of the other cases[11] cited by respondent involve the issue of the year of deductibility of an item of expense—contingent liabilities or disputed liabilities—and do not involve prepaid receipts in any respect.

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[9] Treas. Reg., sec. 1.446-1(c)(1)(ii) (1957).

[10] United States v. Lewis, 340 U.S. 590 (1951); Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931); Healy v. Commissioner, 345 U.S. 278 (1953); Guaranty Trust Co. v. Commissioner, 303 U.S. 493 (1938); Weiss v. Wiener, 279 U.S. 333 (1929); Heiner v. Mellon, 304 U.S. 271 (1938).

[11] Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944); Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934); Brown v. Helvering, 291 U.S. 193 (1934); Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 (1944); United States v. Anderson, 269 U.S. 422 (1926).

II. PETITIONER'S METHOD OF ACCOUNTING RESULTS IN REPORTING NET INCOME ON AN ANNUAL, NOT A TRANSACTIONAL BASIS

Respondent's constant repetition of the statement that taxable income must be reported on an annual, not a transactional basis would lead one to the conclusion either that petitioner does not report income until a transaction is concluded, or that petitioner does not file tax returns annually. Neither is the case. Petitioner never awaits the conclusion of a membership to compute the profit derived from the membership. And petitioner files its tax returns annually, reflecting therein, in accordance with customary rules of accrual accounting, all of the net income earned during the calendar year.

If petitioner receives advance annual dues of $15.00 from a member of one of its divisions on July 1st of a calendar year, petitioner recognizes and reports as gross income during the calendar year of receipt one-half of the amount received and does not wait until June 30th of the following year to determine whether or not upon completion of the membership there has been a net profit or loss. If, from July 1 to December 31, the expenses incurred by petitioner are $6.50 per member, petitioner reports $1.00 of taxable profit from the membership during the calendar year of receipt. If by June 30th of the following calendar year additional expenses of $8.50 per member are incurred, petitioner reports a loss from the deferred membership dues of $1.00 in the succeeding calendar year even though the over-all result of the transaction is $15.00 income, $15.00 expenses, and no profit whatsoever. This is clearly annual accounting and not transactional accounting, for to the extent that petitioner's obligation to serve the member has expired within the tax-

able year, the gross income, deductible expense and taxable income or loss for such year are reported in petitioner's income tax return. Petitioner does not delay or defer reporting dues as income until the membership is over.

Even a brief glance at the cases relied upon by respondent in support of the proposition that petitioner's method of accounting "fails to satisfy the annual accounting requirement" or constitutes "transactional accounting" makes it unmistakably clear that these cases either do not involve accrual accounting, or have no bearing upon the computation of income where prepaid receipts are involved.

Burnet v. *Sanford & Brooks Co.*,[12] was a case involving a cash basis taxpayer who could have changed the decision by the simple expedient of electing the long term construction contract method of reporting provided by the Treasury Regulations.

In *Guaranty Trust Co.* v. *Commissioner*,[13] relied upon by respondent, the taxpayer was a deceased individual who employed the cash basis of accounting. The question involved was the year of inclusion in income of the decedent's share of partnership profits where the partnership computed its income on a fiscal year basis. In the context of such facts, it is not hard to understand why the Court employed such language as "circumstances wholly fortuitous may determine the year in which income, whenever earned, is taxable and may thus affect the amount of tax." But it is difficult to understand why this language should be

[12] 282 U.S. 359 (1931).

[13] 303 U.S. 493 (1938).

quoted in a case which involves accrual accounting for prepaid receipts.

Security Flour Mills Co. v. *Commissioner*,[14] concerned the deductibility from concededly earned income in one year of payments made in subsequent years as to which no liability had accrued in the earlier years. This Court disallowed the deduction claimed by Security Mills because the taxpayer's accounting method was "a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system." (at 287).

United States v. *Lewis*,[15] and *Healy* v. *Commissioner*,[16] also dealt with cash basis taxpayers and obviously neither case concerned the issue of the propriety or the techniques of deferral of prepaid receipts permitted under Section 42 of the 1939 Code or Section 451 of the 1954 Code.

With respect to *Spencer, White & Prentis, Inc.* v. *Commissioner*,[17] respondent neglects to explain that this decision was rendered by the same court which in 1959 decided *Bressner Radio, Inc.* v. *Commissioner*,[18] which is the leading decision on the exact issue before the Court in this case. The *Spencer, White & Prentis* case involved the question of the deductibility of a contingent liability. The Second Circuit did not regard this decision as being sufficiently relevant to the problem of tax accounting for "prepaid receipts" to even cite it in the *Bressner* decision.

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[14] 321 U.S. 281 (1944).

[15] 340 U.S. 590 (1951).

[16] 345 U.S. 278 (1953).

[17] 144 F. 2d 45 (2d Cir. 1944), cert. denied 323 U.S. 780 (1944).

[18] 267 F. 2d 520 (2d Cir. 1959).

III. UNDER ACCRUAL ACCOUNTING, THE RECEIPT OF CASH OFTEN PRECEDES ITS INCLUSION IN INCOME AND THE ACTUAL PAYMENT OF AN ITEM OF EXPENSE OFTEN PRECEDES ITS DEDUCTIBILITY

Although this Court has pointed out repeatedly that for purposes of accrual accounting the time when cash is actually received is not controlling for tax purposes, respondent volunteers the following definition of accrual accounting on page 20 of its brief.

> "Under the 'accrual' method, gross income items are reported in the year in which the right to receive them becomes fixed, even though they are not currently receivable, *but no later than the year of actual receipt*; conversely, deduction items are reported in the year in which they are incurred, i.e., when the liability to pay becomes fixed in fact and amount, even though payment is not then due, *but no later than the year of actual payment*." (Italics supplied)

Petitioner strenuously objects to that portion of the definition italicized above. The addition of the italicized phrases to the definition of accrual accounting would not only shock and amaze the accounting profession, but would result in the reversal of long established case law relating both to prepaid deductions and prepaid receipts. It would even reverse the position of the Commissioner of Internal Revenue with respect to many kinds of prepaid receipts and prepaid deductions of accrual basis taxpayers.

Apparently respondent is compelled to take this extreme position in order to make a consistent argument; but there can be no doubt about the fact that respondent's suggested definition goes too far. If, for example, an accrual basis taxpayer prepays rent on leased premises for a period extending beyond the close of its

taxable year, the Commissioner would not think of allowing a deduction in the year of payment for the entire amount of prepaid rent. The deduction must be prorated over the period for which the rent was paid. The case law has been settled on this point for many years. In *Bloedel's Jewelry, Inc.*[19] a calendar year-accrual basis taxpayer sought to obtain a tax deduction in 1920 for one year's rent prepaid to cover the period commencing September 1, 1920 and ending August 31, 1921. The Board of Tax Appeals upheld the determination of the Commissioner of Internal Revenue that only 4 12ths of the rent constituted a valid deduction for 1920. The remaining 8 12ths was not allowed as a deduction until 1921 in order that taxable income should not be distorted. See *Main & McKinney Building Co.* v. *Commissioner*,[20] *Baton Coal Co.*,[21] *Galatoire Bros.* v. *Lines*,[22] *J. Alland & Bro., Inc.* v. *United States*.[23] If an accrual basis taxpayer prepays fire or other insurance premiums for three years, for instance, not only would the Commissioner of Internal Revenue require the taxpayer to prorate the deduction over the period covered, *Higginbotham-Bailey-Logan Co.*,[24] but the Commissioner even requires a cash basis taxpayer to do the same. *Commissioner* v. *Boylston Market Assn.*,[25] *Martha R. Peters*,[26] *Bessie Cohen*,[27] G.C.M.

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[19] 2 B.T.A. 611 (1925).

[20] 113 F. 2d 81 (5th Cir. 1940).

[21] 19 B.T.A. 169 (1930), aff'd 51 F. 2d 469 (3d Cir. 1931).

[22] 23 F. 2d 676 (5th Cir. 1928).

[23] 28 F. 2d 792 (D.C. Mass. 1928).

[24] 8 B.T.A. 566 (1927).

[25] 131 F. 2d 966 (1st Cir. 1942).

[26] 4 T.C. 1236 (1945).

[27] 10 T.C.M. 29 (1951).

23587.[28] See G.C.M. 13148.[29] Similarly, interest prepaid by an accrual basis taxpayer must be deducted pro rata over the period to which the prepayment relates and not entirely in the year of payment. *Higginbotham-Bailey-Logan Co.*[30] And again, with respect to the same principle, expenses incurred by an accrual basis taxpayer in obtaining a loan which extends beyond the close of the taxable year must be deducted pro rata over the period of the loan. See *Longview Hilton Hotel Co.*[31] Clearly, it is not the law that the accrual of a deduction may never follow the year of payment—*where the payment is for an expense which relates to a period after the close of the taxable year.*

Neither is it the law that under accrual accounting prepaid receipts may *never* be accounted for as income later than the taxable year of receipt. In many areas of tax law the Commissioner of Internal Revenue has issued rulings[32] that prepaid receipts do not constitute

[28] 1943 C.B. 213.

[29] XIII-1 C.B. 67 (1936).

[30] 8 B.T.A. 566 (1927). Interest prepaid by a cash basis taxpayer on the other hand, is deductible when paid. *John D. Fackler*, 39 B.T.A. 395 (1939), acq. 1939-1 C.B. 11.

[31] 9 T.C. 180 (1947), acq. 1947-2 C.B. 3.

[32] Payments received by a travel agent in one year for cruise tickets, when the cruise was to take place the following years should not be accounted for as income in the year of receipt under accrual accounting. I.T. 2080, III-2 C.B. 48 (1924). 2 or 3 year prepaid subscription should be reflected as income pro rata as the magazine is delivered. I.T. 3369, 1940-1 C.B. 46. Advances received by a contractor in connection with long term contracts need not be reflected as income upon receipt. Treas. Reg., sec. 1.451-3 (1957).

income in the year of receipt. If these rulings are valid, the respondent's suggested definition of accrual accounting is invalid. Moreover, the principle which establishes the validity of these rulings should apply equally to all taxpayers similarly situated, including petitioner.

Where advance payments are received by an accrual basis taxpayer in consideration for goods to be delivered in a succeeding year, both the Commissioner of Internal Revenue and the courts have approved postponement of the inclusion of the advance as income until the goods were delivered. In *Veenstra & De Haan Coal Co.*,[33] an accrual basis taxpayer received $11,000 in 1943 for coal which could not be delivered until the following taxable year. Even the Tax Court recognized the error of taxing such advances as income in 1943—despite the fact that taxpayer had the cash on hand at the end of the year—since delivery of coal could not be made until the following year. The Commissioner of Internal Revenue acquiesced.[34] Similarly, in *Woodlawn Park Cemetery Co.*,[35] the Tax Court again held that prepaid receipts for cemetery crypts which were not completed until succeeding taxable years of the recipient did not constitute income to the recipient in the year of receipt—where accrual accounting was employed. Again the Commissioner acquiesced.[36]

The area of dispute now seems to be narrowed down to the year of taxation of prepaid receipts in connection with services to be rendered in the future—as con-

[33] 11 T.C. 964 (1948).

[34] 1949-1 C.B. 4.

[35] 16 T.C. 1067 (1951).

[36] 1951-2 C.B. 4.

trasted with goods to be delivered. There is no distinction between the two under generally accepted accounting principles;[37] and there should be no dispute for tax purposes where the rendition of services must take place in a succeeding year, where the cost of rendering the services cannot be incurred until the succeeding year, and where deferral is essential in order to match prepaid revenue with related expense and to reflect income clearly.

Whenever the problem of accounting for prepaid receipts, in connection with services to be rendered in the future, has been analyzed by the United States Courts of Appeal,[38] the decision has supported sound principles of accrual accounting. Without exception, the decisions of the United States Courts of Appeal which support the respondent's position in this case have been based upon the "claim of right" doctrine[39]—and respondent, in this case, concedes that the claim of right doctrine does not apply.[40]

[37] See authorities cited at 17-19 of petitioner's principal brief and testimony at R. 32, 33.

[38] Bressner Radio, Inc. v. Commissioner, 267 F. 2d 520 (2d Cir. 1959); Schlude v. Commissioner, 283 F. 2d 234 (8th Cir. 1960); Beacon Publishing Co. v. Commissioner, 218 F. 2d 697 (10th Cir. 1955); Bayshore Gardens, Inc. v. Commissioner, 267 F. 2d 55 (2d Cir. 1959).

[39] Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957); Streight Radio and Television, Inc. v. Commissioner, 280 F. 2d 883 (7th Cir. 1960).

[40] Brief for respondent, p. 35 states:

"We agree with taxpayer (Br. 27-30) that the so-called claim of right doctrine is not directly applicable here . . ." The position of the Commissioner of Internal Revenue that prepaid receipts may never constitute taxable income later than the year of receipt is based entirely upon the claim of right doctrine. Rev. Rul. 60-85, 1960-1 C.B. 181. Since the respondent disavows that principle in this case for the first time there is no argument left which would support his position in this case.

IV. THE RESPONDENT'S METHOD OF ACCOUNTING WOULD IMPOSE AN INCOME TAX WHERE NO INCOME EXISTS AND IS PARTICULARLY INEQUITABLE IN THE CASE OF NEW AND GROWING BUSINESSES THAT RECEIVE MONEY IN ADVANCE OF PERFORMANCE

In *Bressner Radio, Inc.* v. *Commissioner*,[11] the Second Circuit pointed out that the method of accounting which the Commissioner sought to impose upon the taxpayer, which received prepaid receipts in connection with television service contracts, would not only distort income but would impose an income tax in years where the taxpayer actually operated at a loss.

Said the Court:

> "Furthermore, to compel this technique for tax purposes would further distort the result, in some cases grievously. Thus, in this case it was apparent to petitioner shortly after it commenced its service business that it would sustain a loss on each contract. Its accounting technique reflected a pro rata portion of that overall loss in each of the years of performance. Had the petitioner adopted what the Commissioner asserts would have been the only proper accounting procedure for tax purposes it would have shown a first-year taxable profit on most contracts, and a second-year loss which would have been heightened by the tax cost imposed in the first. Thus if petitioner had sold a service contract for $100 on April 1, 1948 it would have incurred expenses of $19 for installation and $19.62 for servicing for two months ($9.81 × 2). The balance of $61.38 would have been taxable income in the fiscal year of the sale and would have resulted in a tax of $23.32 (at 38%). This would have left petitioner with $38.06 to meet his service costs over the next ten months

[11] 267 F. 2d 520 (2d Cir. 1959).

> of $98.10. We have no doubt that such a technique of reporting would be a gross distortion of petitioner's income."[42]

In *Schlude* v. *Commissioner*,[43] counsel for taxpayer contended that had the Commissioner of Internal Revenue succeeded in requiring the taxpayer to report advance payments as income before the agreed upon dance lessons were given, the taxpayer would have been insolvent.

To illustrate the inaccuracy and inequity of respondent's method of accounting as applied to motor clubs, let us assume that a new club commences business on January 1, 1962 with a single member and adds one new member on the first day of each month for a 24 month period. For the sake of simplicity, let us assume that annual dues are $12 per member per year, payable in advance, and that the actual cost of serving one member per month is $1.00—an exact break even situation. During its first year of operations the aggregate advance dues collected by the club would be $144 (12 members × $12). Its expenses at $1.00 per member per month would total only $78 since its obligation to perform is only half completed. Respondent's position is that the club earned $66 of taxable income during its first calendar year and owes an income tax thereon. Under petitioner's method of accounting the club breaks even, of course. During the second year if a new member is added each month and all old members rejoin the aggregate advance dues collected total $288 (24 members × $12). Expenses at $1.00 per member per month equal $222, and again the

[42] 267 F. 2d at 524.

[43] 283 F. 2d 234 (8th Cir. 1960).

respondent contends that the club has a net profit of $66 and should pay an income tax thereon. In the third year, if the membership levels out at 24, the club collects advance dues of $288 and has expenses of $288, and it becomes clear the club has no profit.

Although it should be obvious from the foregoing example that the club has never earned any profit, the respondent's method of accounting would require the club to pay income taxes on a fictitious profit of $132. After taxes, the club would not have available adequate resources with which to meet its obligations since the club owes its members, in the aggregate, 132 months of future services which at the present rate will cost $1.00 per member per month. But the funds available to the club to provide such services are $132 less income taxes. So long as the membership of the club remains constant, the club will never recover the income taxes paid to the government in years when the club earned no income. While incongruous, it is true that under respondent's method of accounting, the faster the club grows, the sooner it approaches insolvency.

V. THERE IS NO VALIDITY TO RESPONDENT'S ARGUMENT WITH RESPECT TO EASE OF ADMINISTRATION

The respondent argues that advance receipts must be accounted for as taxable income no later than the year of receipt because this would facilitate administration of the tax laws from the point of view of the Commissioner of Internal Revenue. Respondent even contends there is no merit in computing income in a manner which matches expenses with related revenue for this would result in an

> " . . . enormous burden of evaluating and verifying complex statistical evidence submitted by mil-

> lions of taxpayers in an endless variety of business contexts to prove that they have reliably 'related' and 'matched' present income with estimated future expenses, or present expenses with estimated future income." [44]

Petitioner concedes that it would be more simple to administer the tax laws if all taxpayers were required to employ the cash method of accounting rather than the accrual method, but such is not the case. Administrative convenience to the Treasury Department should not outweigh legitimate interests of a taxpayer based upon express statutory authority, or permit the Commissioner to force the taxpayer to change from a long standing method of accounting which clearly reflects income to one which does not. Furthermore petitioner does not agree that the method of accounting which it seeks to sustain is complex. If advance receipts are not includible in income on a cash basis but on an accrual basis, the time of includibility is determined by the delivery of goods or the rendition of services. Neither of these events is unduly complex. In the "Handbook of Accounting Methods" (1943 edition, edited by J. K. Lasser), the section dealing with accounting methods for clubs provides, on page 517:

> " . . . Where dues are payable yearly in advance, and monthly income and expense statements are prepared, the proportionate amount of dues receivable for the month should be taken into income, and the unearned balance should be shown on the balance sheet as deferred income. . . . "

Insofar as a motor club is concerned, if advance dues are not required to be reported as taxable income on a cash basis, they are reportable as income during a tax-

[44] Brief for respondent, p. 33.

able year to the extent that petitioner's obligation to render or make available services to its members expires within the year. This is a simple yardstick. Similarly, if a manufacturer employing the accrual method of accounting receives payments in advance of delivery of goods, the advances are taken into account at the time of delivery. This is hardly complex.

Respondent also argues that the use of generally accepted accounting principles as applied to prepaid receipts gives too much flexibility to the taxpayer in computing income, but respondent confuses unwarranted flexibility with permissible choice. Even if there were an element of flexibility, there are numerous areas in the Internal Revenue Code in which a taxpayer may exercise a choice which has a bearing upon the computation of net income. As pointed out in a recent article, written by Robert Behren, entitled "Prepaid Income—Accounting Concepts and the Tax Law":

> "The choice of methods of valuing inventories, computing depreciation, and determining bad debt deductions; the adoption of the taxable year, the installment method, and the long-term contract method; even the basic determination of the method of accounting to be applied—all have an effect on the taxable income of an enterprise. Certainly, if the taxpayer is given the right to choose between the cash receipts and disbursements method and the accrual method in the first place, the Treasury should not complain of some lesser elections within the method chosen if in accord with 'generally accepted accounting principles.' The difference in taxable income of a business computed on the cash basis as compared to the accrual basis will generally be far greater than between taxable incomes computed on the accrual

basis where different accounting 'principles' are applied."[45]

Certainly, the Commissioner of Internal Revenue should accept the reasonable method employed by petitioner of reflecting advance dues as revenue over the period of a membership rather than entirely in the year of receipt, if consistently employed, and if income is clearly reflected.

VI. COMMERCIAL ACCOUNTING AND TAX ACCOUNTING ARE SYNONYMOUS TERMS IF INCOME IS CLEARLY REFLECTED EXCEPT IN THOSE INSTANCES WHERE THE INTERNAL REVENUE CODE PROVIDES TO THE CONTRARY

Respondent argues[46] that the Commissioner of Internal Revenue is not bound by commercial accounting principles; but this argument has no application to the disposition of this case since the use of standard accounting principles does reflect petitioner's income clearly.

The decisions of this Court cited by respondent[47] in support of its argument that commercial and tax accounting are different fail to supply any reasons for a departure from sound accounting principles where the taxation of prepaid receipts is in issue. In *Brown* v. *Helvering*, the taxpayer sought to change its method

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[45] Behren, "Prepaid Income—Accounting Concepts and the Tax Law", 17 Tax L. Rev. 343, 365 (1960).

[46] Brief for Respondent, pp. 36-41.

[47] Brown v. Helvering, 291 U.S. 193 (1934); Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944); Lucas v. American Code Co., 280 U.S. 445 (1930); Bazley v. Commissioner, 331 U.S. 737 (1947), reh. denied 332 U.S. 752 (1947); Commissioner v. Hansen, 360 U.S. 446 (1959).

of accounting without the required approval of the Commissioner of Internal Revenue, an important fact not present in this case. In *Lucas* v. *American Code Co.*, the taxpayer sought to deduct a loss in connection with a breach of contract where the contract had "18 more years to run", where "liability for the breach was denied and strenuously contested . . .", and where "the amount of the damages, if any, was wholly unpredictable."[48] In *Bazley* v. *Commissioner of Internal Revenue* this Court determined that the corporate reorganization provisions were not intended to exempt from taxation the exchange of common stock for negotiable bonds which as a practical matter constituted *realized* gain. In *Commissioner* v. *Hansen* an accrual basis taxpayer was not permitted to escape accrual and taxation of that portion of its income derived from sales which the taxpayer permitted to be retained by a finance company as collateral security.

None of these cases involve correct accrual accounting for prepaid receipts. The only reference in such cases to a divergence, if any, between commercial accounting and tax accounting, was that corporate bookkeeping with respect to the nature of a transaction was not necessarily binding on the court. A holding to this effect is obviously not the same as a determination that cardinal principles of accrual accounting should be ignored in computing taxable income where advance payments are involved.

Respondent's argument also relegated to limbo the long standing regulations promulgated by the Commissioner of Internal Revenue which clearly approve the use of "standard methods of accounting" for federal

[48] 280 U.S. at 451.

income tax purposes—if regularly employed and if income is clearly reflected. The principle of accrual accounting which requires prepaid receipts to be reflected as revenue when services are provided or goods are delivered is one of the cornerstones of accrual accounting according to petitioner's accounting experts. Its use is required not for a conservative but an accurate determination of net income.

If we ignore the Commissioner's regulations approving the use of standard accounting principles in computing taxable income—provided income is clearly reflected—there is no suitable substitute for determining when or whether annual income is clearly reflected.

VII. NEITHER THE ENACTMENT AND REPEAL OF SECTIONS 452 AND 462 OF THE INTERNAL REVENUE CODE OF 1954 NOR PETITIONER'S EFFORTS TO CURE BY LEGISLATION THE INEQUITABLE TAX TREATMENT OF PREPAID DUES WHICH RESPONDENT SEEKS TO FORCE UPON PETITIONER HAS ANY BEARING UPON THE DISPOSITION OF THIS LITIGATION.

In order to persuade Congress to repeal retroactively the provisions of Section 452 and 462 of the Internal Revenue Code of 1954, the Secretary of the Treasury gave his solemn word to the Congress that no inferences would be drawn from such repeal with respect to the status of prior law.

Despite this assurance 11 pages of respondent's brief[49] are devoted to the argument that the repeal of these sections does show "a Congressional understanding that no such method was permissible under existing law, . . ."[50]

[49] Brief for respondent, pp. 42-53.

[50] Brief for respondent, p. 45.

The exact language of the promise of the Secretary of the Treasury was contained in a letter to the Honorable Jere Cooper, then Chairman of the Committee on Ways and Means. It was dated March 22, 1955, and reads as follows:

> "My dear Mr. Chairman: This letter will confirm the statements made to you today by Treasury representatives.
>
> "I assure your committee that if H.R. 4725 as reported out by your committee is enacted, as I earnestly hope it will be, the Treasury Department will apply revenue ruling 54-608 (relating to the accrual of vacation pay) only to taxable years ending after December 31, 1955.
>
> "Furthermore, the Treasury Department will not consider the repeal of section 452 as any indication of congressional intent as to the proper treatment of prepaid subscriptions and other items of prepaid income, *either under prior law or under other provisions of the 1954 code.* In other words, the repeal of section 452 will not be considered by the Department as either the acceptance or the rejection by Congress of the decision in *Beacon Publishing Co.* v. *Commissioner* (218 F. (2d) 697, C. A. 10, 1955) or any other judicial decisions.
>
> "It is my understanding *that the foregoing is consistent with the desire of your committee, with which I agree,* that the repeal of sections 452 and 462 should operate simply to reestablish the principles of law which would have been applicable if sections 452 and 462 had never been enacted."[51] [Italics supplied.]

[51] H.R. Rep. No. 293, 84th Cong., 1st Sess. 5 (1955).

The legislative history of the repeal of Sections 452 and 462 is equally clear on the point that Congress did not intend to disturb prior law.[52]

The *Beacon Publishing Company* case on which petitioner relies correctly interpreted existing law prior to the enactment of Section 452; the *Bressner Radio* and *Schlude* cases upon which petitioner relies correctly interpreetd existing law after the repeal of these sections. No inferences were drawn by these courts.

Respondent in this and other portions of its brief also seeks to give the impression that a decision in favor of petitioner might result in a substantial loss in tax revenue comparable to the loss anticipated by the Treasury Department if Sections 452 and 462 had not been repealed. Respondent fails to explain, however, that the loss in revenue which was anticipated as a result of the enactment of these sections stemmed from "the transition period."[53] In other words, in

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[52] "Your committee in repealing sections 452 and 462 does not intend to disturb prior law as it affected permissible accrual accounting provisions for tax purposes, including the treatment of prepaid newspaper subscriptions." H. Rep. No. 293, 84th Congr., 1st Sess. 4 (1955).

"Uncertainty will also exist in other areas with the repeal of these two provisions. In *Pacific Grape Products* (C.C.A. 9th, February 10, 1955) [219 F. 2d 862], for example, the circuit court held that certain freight and shipping expenses incurred after the end of the year could be accrued for tax purposes as of the end of the year. An extension of the principles laid down in this case might well lead the courts in the future to permit the accrual of most estimated expenses which would be covered by section 462 even though this section is repealed." (S. Rep. No. 372, 84th Congr., 1st Sess. 5, 6 (1955).

[53] See H. Rep. No. 293, 84th Cong., 1st Sess. 3 (1955); S. Rep. No. 372, 84th Cong., 1st Sess. 4 (1955).

the year of transition a taxpayer received a deduction not only for the actual expenses incurred in such year but also for the newly created reserves for various expenses which would not be incurred until subsequent years. The often referred to "double" deduction in one year—the year of transition—was the primary cause of the anticipated revenue loss.

The double deduction was possible because these sections authorized a change in accounting methods without the customary consent of the Commissioner of Internal Revenue. Since petitioner is not seeking to change its long standing method of accounting, there is no transitional problem.

Petitioner's efforts to obtain legislation putting to an end any doubt about the right of a nonprofit motor club to report prepaid dues as income over the membership period commenced prior to the decision of this Court in *Automobile Club of Michigan* and have continued following such decision. As long as any motor club which employs the accrual method of accounting is denied the right to report prepaid dues over the membership period rather than in the year of receipt, petitioner, as representative of all motor clubs affiliated with the AAA, has the responsibility of seeking redress if possible. Its efforts, however, have no bearing upon the interpretation of Sections 446 and 451 of the Internal Revenue Code of 1954 nor of Sections 41 and 42(a) of the Internal Revenue Code of 1939—nor upon whether the income of any particular club is clearly reflected. Moreover, petitioner's efforts were not directed toward changing existing law, since there was no United States Supreme Court decision declaratory of existing law, but instead were directed toward eliminating the confusion which existed because of diverse

lower court decisions on the subject of accounting for prepaid receipts.

Respondent, prior to the decision of this Court in *United States* v. *Cannelton Sewer Pipe Company*,[54] sought to have Congress change the definition of "mining" for the purpose of computing percentage depletion to the definition actually approved by this Court in the *Cannelton* case.[55] Surely, if respondent has the prerogative of requesting legislation to end all doubt at the same time it is attempting to persuade the courts to adopt an interpretation of existing law which coincides with the legislation it seeks, the same privilege should not be denied a taxpayer.

CONCLUSION

For the first time in any income tax case involving proper accrual accounting for prepaid receipts, respondent admits that the "claim of right" doctrine is not directly applicable. Since such victories as Respondent has won on this issue, other than *Automobile Club of Michigan*, have been grounded on this theory, Respondent's abandonment of this argument in this case is not only surprising but revealing.

Respondent's substitute for the discarded claim of right argument is the simple equation that even in the

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[54] 364 U.S. 76 (1960).

[55] See letter of Secretary of the Treasury to Speaker of the House of Representatives dated January 26, 1959, found in the Congressional Record—Senate, June 18, 1960, at page 12,286. See also Congressional Record—Senate, June 18, 1960, at pages 12,283-12,310; June 20, 1960, pages 12,418-12,420; June 27, 1960, (the date on which the *Cannelton* decision was rendered), pages 13,461-13,465. See also Hearings Before the Committee on Ways and Means, House of Representatives, 86th Congress, 1st Session, March 5, 6, 9, 10 and 11, 1959.

case of an accrual basis taxpayer: prepaid receipts = taxable income. Respondent seeks to buttress this equation with a novel addition to the long standing definition of accrual accounting as approved by this Court. The addition is that money may never be accounted for as taxable income in a year subsequent to the year of receipt and items of expense may never be allowed as a deduction in a year subsequent to the year of payment. Insofar as prepaid receipts are concerned, the net effect of this new addition would be to authorize the Commissioner of Internal Revenue to either collect his income tax on the cash method of accounting or the accrual method of accounting, whichever results in earlier taxation, and irrespective of whether or not income is clearly reflected. Insofar as prepaid expenses are concerned, the respondent has not in the past and is not expected in the future to permit the deduction in one year of more than one year's expenses, his argument in this case to the contrary notwithstanding. The obviously unfair effort of the Commissioner to work both sides of the same street to his earliest and exclusive advantage should result in the early failure of this new approach.

Petitioner respectfully requests that the issue in this case should be resolved in the light of the applicable statutes which approve the use of accrual accounting for income tax purposes provided income is clearly reflected, and in the light of the Commissioner's own regulations that the use of standard accounting principles will be an acceptable yardstick to measure whether income is clearly reflected. In this case deferral of a pro-rata part of prepaid dues is essential in order to match in the same taxable

periods the cost of serving petitioner's members with related revenue.

Petitioner in this case has established as a fact that its method of accounting does reflect its income clearly. It has also proved the respondent's method does not. It has proved that no reputable accountant will certify to the accuracy of its profit and loss statements or its balance sheets if it is forced to accept respondent's method of accounting. Upon the facts established in this case, petitioner respectfully requests that the judgment of the Court of Claims should be reversed.

Respectfully submitted,

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SUPREME COURT OF THE UNITED STATES

No. 288.—October Term, 1960.

American Automobile Association, Petitioner, v. United States. | On Writ of Certiorari to the United States Court of Claims.

[June 19, 1961.]

Mr. Justice Clark delivered the opinion of the Court.

In this suit for refund of federal income taxes the petitioner, American Automobile Association, seeks determination of its tax liability for the years 1952 and 1953. Returns filed for its taxable calendar years were prepared on the basis of the same accrual method of accounting as was used in keeping its books. The Association reported as gross income only that portion of the total prepaid annual membership dues, actually received or collected in the calendar year, which ratably corresponded with the number of membership months, covered by those dues, occurring within the same taxable calendar year. The balance was reserved for ratable monthly accrual over the remaining membership period in the following calendar year as deferred or unearned income reflecting an estimated future service expense to members. The Commissioner contends that petitioner should have reported in its gross income for each year the entire amount of membership dues actually received in the taxable calendar year without regard to expected future service expense in the subsequent year. The sole point at issue, therefore, is in what year the prepaid dues are taxable as income.

In auditing the Association's returns for the years 1952 through 1954, the Commissioner, in exercise of his discre-

tion under § 41 of the Internal Revenue Code of 1939,[1] determined not to accept the taxpayer's accounting system. As a result, adjustments were made for those years principally by adding to gross income for each taxable year the amount of prepaid dues which the Association had received but not recognized as income, and subtracting from gross income amounts recognized in the year although actually received in the prior year. A net operating loss claimed for 1954 and corresponding carryback deductions were greatly reduced, and tax deficiencies were assessed for 1952 and 1953. Petitioner paid the deficiencies and its timely claim for refund was denied. Suit to recover was instituted in the Court of Claims, but the court sustained the Commissioner, 181 F. Supp. 255. Recognizing a conflict between the decision below and that in *Bressner Radio, Inc.*, v. *Commissioner*, 267 F. 2d 520, we granted certiorari. 364 U. S. 813. We have concluded that for tax purposes the dues must be included as income in the calendar year of their actual receipt.

The Association is a national automobile club organized as a nonstock membership corporation with its principal office in Washington, D. C. It provides a variety of services[2] to the members of affiliated local automobile clubs and those of ten clubs which taxpayer itself directly

[1] A taxpayer's "net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books . . . but . . . if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. . . ." 53 Stat. 24, 26 U. S. C. (1952 ed.) § 41. See also the similar provision in the Internal Revenue Code of 1954, 26 U. S. C. (1958 ed.) § 446.

[2] These generally include road maps, routing, tour books, etc.; emergency road service through contracts with local garages; bail bond protection; personal automobile accident insurance and theft protection; and, in some of its divisions, motor license procurement, brake and headlight adjustment service, notarial duties and advice in the prosecution of small claims.

operates as divisions, but such services are rendered solely upon a member's demand. Its income is derived primarily from dues paid one year in advance by members of the clubs. Memberships may commence or be renewed in any month of the year. For many years, the association has employed an accrual method of accounting and the calendar year as its taxable year. It is admitted that for its purposes the method used is in accord with generally accepted commercial accounting principles. The membership dues, as received, were deposited in the Association's bank accounts without restriction as to their use for any of its corporate purposes. However, for the Association's own accounting purposes the dues were treated in its books as income received ratably[3] over the 12-month membership period. The portions thereof ratably attributable to membership months occurring beyond the year of receipt, *i. e.*, in a second calendar year, were reflected in the Association's books at the close of the first year as unearned or deferred income. Certain operating expenses were chargeable as prepaid membership cost and deducted ratably over the same periods of time as those over which dues were recognized as income.

The Court of Claims bottomed its opinion on *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180 (1957), finding that "the method of treatment of prepaid automobile club membership dues employed [by the Association here was] . . . for Federal income tax pur-

[3] In 1952 and 1953 dues collected in any month were accounted as income to the extent of one-twenty-fourth for that month (on the assumption that the mean date of receipt was the middle of the month), one-twelfth for each of the next eleven months, and again one-twenty-fourth in the anniversary month. In 1954, however, guided by its own statistical average experience, the Association changed its system so as to more simply reach almost the same result by charging to year of receipt, without regard to month of receipt, one-half of the entire dues payment and deferring the balance to the following year.

poses, 'purely artificial.'" 181 F. Supp. 255, 258. It accepted that case as "a rejection by the Supreme Court of the accounting method advanced by plaintiff in the case at bar." *Ibid.* The Association does not deny that its accounting system is substantially identical to that used by the petitioner in *Michigan*. It maintains, however, that *Michigan* does not control this case because of a difference in proof, *i. e.*, that in this case the record contains expert accounting testimony indicating that the system used was in accord with generally accepted accounting principles; that its proof of cost of member service was detailed, and that the correlation between that cost and the period of time over which the dues were credited as income was shown and justified by proof of experience. The holding of *Michigan*, however, that the system of accounting was "purely artificial" was based upon the finding that "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year." 353 U. S. 180, 189, note 20. That is also true here.[4] As the Association's own accounting expert testified:

> "You are dealing with a group or pool. Any pooling or risk situation, particular members may in a particular year require very little of a specific service that is rendered to certain other members. I wouldn't know what the experience on that would be, but I would think it would be rather irregular between individual members . . . I am buying the availability of services, the protection . . . . Frankly,

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[4] *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697, and *Schuessler* v. *Commissioner*, 230 F. 2d 722, may be distinguished from the present case on the same grounds which made them distinguishable in *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180, 189, note 20.

> the irregularity of the actual furnishing of the maps and helping you out when you run out of gasoline and so on. I frankly don't think that has a blessed thing to do with the overall accounting."

It may be true that to the accountant the actual incidence of cost in serving an individual member in exchange for his individual dues is inconsequential, or, from the viewpoint of commercial accounting, unessential to determination and disclosure of the overall financial condition of the Association. That "irregularity," however, is highly relevant to the clarity of an accounting system which defers receipt, as earned income, of dues to a taxable period in which no, some, or all the services paid for by those dues may or may not be rendered. The Code exacts its revenue from the individual member's dues which, no one disputes, constitute income. When their receipt as earned income is recognized ratably over two calendar years, without regard to correspondingly fixed individual expense or performance justification, but consistently with overall experience, their accounting doubtless presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner.

The Association further contends that the findings of the court below support its position. We think not. The Court of Claims' only finding as to the accounting system itself is as follows:

> "22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices and was, prior to the adverse determination by the Commissioner of the Internal Revenue, customarily and generally employed in the motor club field."

This is only to say that in performing the function of business accounting the method employed by the Association "is in accord with generally accepted commercial accounting principles and practices." It is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury.[5] Likewise, other findings merely reflecting statistical computations of average monthly cost per member on a group or pool basis are without determinant significance to our decision that the federal revenue cannot, without legislative consent and over objection of the Commissioner, be made to depend upon average experience in rendering performance and turning a profit. Indeed, such tabulations themselves demonstrate the inadequacy from an income tax standpoint of the *pro rata* method of allocating each year's membership dues in equal monthly installments not in fact related to the expenses incurred. Not only did individually incurred expenses actually vary from month to month, but even the average expense varied—recognition of income nonetheless remaining ratably constant. Although the findings below seem to indicate that it would produce substantially the same result as that of the system of ratable monthly recognition actually employed, we consider similarly unsatisfactory, from an income tax standpoint, allocation of monthly dues to gross monthly income to the extent of actual service expenditures for the same month computed on a group or pool basis. In addition, the Association's election in 1954 to change its monthly recognition formula [6] to one which treats one-half of the dues as income in the year of receipt and the other half as income received in the subsequent

[5] The Hearing Commissioner of the Court of Claims had specifically found as fact that petitioner's "method of accounting . . . clearly reflected its net income for such years." The court, however, did not adopt that finding.

[6] See note 2, *supra*.

year, without regard to month of payment, only more clearly indicates the artificiality of its method, at least so far as controlling tax purposes are concerned. Moreover, the Association realized that the findings of the Court of Claims were not alone sufficient for its purposes. In its petition for rehearing below, petitioner specifically asked that they be amended and enlarged, especially as to No. 22 set out above. Rehearing and amendment were denied.

Whether or not the Court's judgment in *Michigan* controls our disposition of this case, there are other considerations requiring our affirmance. They concern the action of the Congress with respect to its own positive and express statutory authorization of employment of such sound commercial accounting practices in reporting taxable income. In 1954 the Congress found dissatisfaction in the fact that "as a result of court decisions and rulings, there have developed many divergencies between the computation of income for tax purposes and income for business purposes as computed under generally accepted accounting principles. The areas of difference are confined almost entirely to questions of when certain types of revenue and expenses should be taken into account in arriving at net income." House Ways and Means Committee Report, H. R. Rep. No. 1337, 83d Cong., 2d Sess. 48. As a result, it introduced into the Internal Revenue Code of 1954 § 452 and § 462[7] which specifically permitted essentially the same practice as was employed by the Association here.[8] Only one year later, however,

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[7] 26 U. S. C. (1952 ed., Supp. II) §§ 452, 462, repealed, 69 Stat. 134 (1955).

[8] The Senate Report included this language:

"Under the 1939 Code, regardless of the method of accounting . . . amounts are includible in gross income by the recipient not later than the time of receipt if they are subject to free and unrestricted use

in June 1955, the Congress repealed these sections retroactively. It appears that in this action Congress first overruled the long administrative practice of the Commissioner and holding of the courts in disallowing such deferral of income for tax purposes and then within a year reversed its own action. This repeal, we believe, confirms our view that the method used by the Association could be rejected by the Commissioner. While the claim is made that Congress did not "intend to disturb prior law as it affected permissible accrual accounting provisions for tax purposes. . . ." H. R. Rep. No. 293, 84th Cong., 1st Sess. 4, the cold fact is that it repealed the only law incontestably permitting the practice upon which the Association depends. To say that, as to taxpayers using such systems, Congress was merely declaring existing law when it adopted § 452 in 1954, and that it was merely restoring unaffected the same prior law when it repealed the new section in 1955 for good reason, is a contradiction in itself, "varnishing nonsense with the charm of sound." Instead of constituting a merely duplicative creation, the fact is that § 452 for the first time specifically declared petitioner's system of accounting to be acceptable for income tax purposes, and overruled the long-standing position of the Commissioner and courts to the contrary. And the repeal of the section the following year, upon insistence by the Treasury that the proposed endorsement of such tax accounting would have a disastrous impact on the Government's revenue, was just as clearly a mandate from the Congress that petitioner's system was not acceptable for tax purposes. To interpret its careful consideration of the problem otherwise is to accuse the Congress of engaging in sciamachy. We are further confirmed in this view by consideration of the even

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by the taxpayer even though the payments are for goods or services to be provided by the taxpayer at a future time." S. Rep. No. 1622, 83d Cong., 2d Sess. 301.

more recent action of the Congress in 1958, subsequent to the decision in *Michigan, supra.* In that year § 455 [9] was added to the Internal Revenue Code of 1954. It permits publishers to defer receipt as income of prepaid subscriptions of newspapers, magazines and periodicals. An effort was made in the Senate to add a provision in § 455 which would extend its coverage to prepaid automobile club membership dues.[10] However, in conference the House Conferees refused to accept this amendment. Senator Byrd explained the rejection of the amendment to the Senate (104 Cong. Rec., Part 14, p. 17744):

> "It was the position of the House conferees that this matter of prepaid dues and fees received by nonprofit service organizations was a part of the entire subject dealing with the treatment of prepaid income and that such subject should be left for study of this entire problem. . . ." [11]

It appears, therefore, that, pending its own further study, Congress has given publishers but denied automobile clubs the very relief that the Association seeks in this Court.

To recapitulate, it appears that Congress has long been aware of the problem this case presents. In 1954 it en-

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[9] 28 U. S. C. (1958 ed.) § 455.

[10] An unsuccessful attempt to induce congressional action on this problem was made last year, see H. R. 11266, 86th Cong., 2d Sess., which passed in the House in August, 1960, 106 Cong. Rec. (Daily ed.) 16256 but failed to draw any action by the Senate before adjournment. An identical bill is currently pending, see H. R. 929, 87th Cong., 1st Sess., and H. R. Rep. No. 381 accompanying the bill and recommending its passage. Under that measure the taxpayer's liability to its members "*shall be deemed to exist ratably* over the period that such services are required to be rendered, or . . . privileges . . . made available."

[11] The Eighty-fourth Congress started the study of "legislation dealing with prepaid income and reserves for estimated expenses . . . ." S. Rep. No. 372, 84th Cong., 1st Sess. 6.

acted § 452 and § 462, but quickly repealed them. Since that time Congress has authorized the desired accounting only in the instance of prepaid subscription income, which, as was pointed out in *Michigan*, is ratably earned by performance on "publication dates after the tax year." 353 U. S. 180, 189, note 20. It has refused to enlarge § 455 to include prepaid membership dues. At the very least, this background indicates congressional recognition of the complications inherent in the problem and its seriousness to the general revenue. We must leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications. The Committees of the Congress have standing committees expertly grounded in tax problems, with jurisdiction covering the whole field of taxation and facilities for studying considerations of policy as between the various taxpayers and the necessities of the general revenues. The validity of the long established policy of the Court in deferring, where possible, to congressional procedures in the tax field is clearly indicated in this case.[12] Finding only that, in light of existing provisions not specifically authorizing it, the exercise of the Commissioner's descretion in rejecting the Association's accounting system was not unsound, we need not anticipate what will be the product of further "study of this entire problem."

Affirmed.

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[12] In 1955 it was estimated that transitional loss of revenue under § 452 and § 462, repealed that year, would total in excess of a billion dollars. H. R. Rep. No. 293, 84th Cong., 1st Sess. 3. That this impact on the revenue continues to be an important factor in congressional consideration of the problem is indicated by the observation of the House Committee on Ways and Means that a "transitional rule" is necessary "to minimize the initial revenue impact" of the measure currently pending. H. R. Rep. No. 381, 87th Cong., 1st Sess. 4. That the system used by petitioner here is, perhaps, presently not uncommon may be indicated by the fact that during this Term alone several cases involving similar systems have reached this Court.

SUPREME COURT OF THE UNITED STATES

No. 288.—October Term, 1960.

American Automobile Association, Petitioner, v. United States. } On Writ of Certiorari to the United States Court of Claims.

[June 19, 1961.]

Mr. Justice Stewart, whom Mr. Justice Douglas, Mr. Justice Harlan and Mr. Justice Whittaker join, dissenting.

In *Automobile Club of Michigan* the Court pointed out that the method of accounting employed by the taxpayer was "purely artificial," so far as the record there showed. 353 U. S., at 189. Here, by contrast, the petitioner proved, and the Court of Claims found, that the method of accounting employed by the petitioner during the years in issue was in accord with generally accepted commercial accounting principles and practice, was customarily employed by similar taxpayers, and, in the opinion of qualified experts in the accounting field, clearly reflected the petitioner's net income. I do not understand that the Court today questions either that proof or those findings.[1]

[1] The Court does not, for example, challenge Finding No. 26 of the Court of Claims:

"Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed."

The Court thus holds that the Commissioner is authorized to disregard and override a method of reporting income under which prepaid dues are deferred in direct relation to the taxpayer's costs under its membership contracts. The effect of the Court's decision is to allow the Commissioner to prevent an accrual basis taxpayer from making returns in accordance with the accepted and clearly valid accounting practice of excluding from gross income amounts received as advances until the right to such amounts is earned by rendition of the services for which the advances were made. To permit the Commissioner to do this, I think, is to ignore the clear statutory command that a taxpayer must be allowed to make his returns in accord with his regularly employed method of accounting, so long as that method clearly reflects his income.[2] The result, I am afraid, will be to engender far-reaching confusion and injustice in the administration of the Internal Revenue Laws.[3]

I.

The Commissioner's basic argument against the deferred reporting of prepayments has traditionally been that such

[2] Int. Rev. Code of 1939, § 41, 53 Stat. 24; Int. Rev. Code of 1954, § 446, 26 U. S. C. § 446.

[3] The scope of the problem is well illustrated by the reported cases. See, *e. g.*, *South Dade Farms* v. *Commissioner*, 138 F. 2d 818 (rent received in advance); *Clay Sewer Pipe Assn.* v. *Commissioner*, 139 F. 2d 130 (subscriptions for promotion campaign to be consummated in years subsequent to receipt); *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697 (advance newspaper subscription payments); *Bressner Radio, Inc.*, v. *Commissioner*, 267 F. 2d 520 (advance payments in a television servicing contract); *Scalude* v. *Commissioner*, 283 F. 2d 234 (fees for dancing lessons paid in advance); *Wallace A. Moritz*, 21 T. C. 622 ("customers' deposits" on undeveloped photographs); *South Tacoma Motor Co.*, 3 T. C. 411 (proceeds from sale of coupons entitling bearer to garage services in later years); *Your Health Club, Inc.*, 4 T. C. 385 (advance payments for use of gym and other facilities); *Northern Illinois College of Optometry*, 2 CCH Tax Ct. Mem. 664 (tuition paid in advance).

a method conflicts with a series of decisions of this Court which establish the so-called "claim of right doctrine." [4] In this case the Government abandoned that argument, with good reason. As four Circuits have correctly held, the claim of right doctrine furnishes no support for the Government's position. *Bressner Radio, Inc.*, v. *Commissioner*, 267 F. 2d 520, 524, 525–528 (C. A. 2d Cir.); *Schlude* v. *Commissioner*, 283 F. 2d 234 (C. A. 8th Cir.); *Schuessler* v. *Commissioner*, 230 F. 2d 722, 725 (C. A. 5th Cir.); *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697, 699–701 (C. A. 10th Cir.).[5] A claim of right without "restriction on use" may be the crucial factor in determining that particular funds are includable in gross income. See *North American Oil* v. *Burnet*, 286 U. S. 417; *United States* v. *Lewis*, 340 U. S. 590; *Healy* v. *Commissioner*, 345 U. S. 278. But it hardly follows that all such funds must necessarily be reported by an accrual basis taxpayer as income in the year of receipt, whether or not then earned.

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[4] Almost all of the decisions sustaining the Commissioner's disallowance of deferred reporting of advances by accrual basis taxpayers have relied on the claim of right doctrine. See, *e. g.*, *Curtis R. Andrews*, 23 T. C. 1026, 1032–1033 (Tax Court); *South Dade Farms* v. *Commissioner*, 138 F. 2d 818 (C. A. 5th Cir.) (but compare *Schuessler* v. *Commissioner*, 230 F. 2d 722; *Clay Sewer Pipe Assn.* v. *Commissioner*, 139 F. 2d 130 (C. A. 3d Cir.); *Automobile Club of Michigan* v. *Commissioner*, 230 F. 2d 585, 591 (C. A. 6th Cir.), aff'd on other grounds, 353 U. S. 180. The Tax Court has carried the claim of right doctrine to the point where it was found applicable to advance fees which were due but not yet paid. *Your Health Club, Inc.*, 4 T. C. 385.

[5] The rejection of the applicability of the claim of right doctrine in these cases has been enthusiastically approved by legal commentators. See, *e. g.*, Gelfand, The "Claim of Right" Doctrine, 33 Taxes 726; Wolder, Deduction of Reserves for Future Expenses and Deferring of Prepaid Income, 34 Taxes 524; Note, 59 Col. L. Rev. 942, 946. But cf. Freeman, Tax Accrual Accounting for Contested Items, 56 Mich. L. Rev., 727, 730–732, 747.

The Government shifted its argument in this case to the contention that the "annual accounting requirement" demands that "[n]either income nor deduction items may be accelerated or postponed from one taxable year to another in order to reflect the long-term economic result of a particular transaction or group of transactions." The Government finds a basis for this argument in such cases as *Security Mills Co.* v. *Commissioner*, 321 U. S. 281; *Brown* v. *Helvering*, 291 U. S. 193; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Guaranty Trust Co.* v. *Commissioner*, 303 U. S. 493; and *Hener* v. *Mellon*, 304 U. S. 271.

The Court today does not base its decision on this theory, presumably because the Court believes, as I do, that the theory is not valid. Putting to one side the point that many of the cases relied on involved cash basis taxpayers,[6] these decisions no more pertain to deferred reporting of totally unearned receipts than do the claim of right decisions. These cases, like the claim of right cases, start from the premise that the income in question

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[6] See, *e. g.*, *Guaranty Trust Co.* v. *Commissioner*, 303 U. S. 493; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359. In the latter case, the Court took special notice of the fact that the taxpayer had not "attempted to avail itself" of the accrual sytem under which "expenses of a transaction incurred in one year might be offset by the amounts actually received from it in another." 282 U. S., at 366. In *Security Mills Co.* v. *Commissioner*, 321 U. S. 281, the taxpayer was attempting to use what the Court described as "a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system." 321 U. S., at 287. In *Brown* v. *Helvering*, 291 U. S. 193, the taxpayer was on accrual basis generally, but its assertion of a right to defer reporting "overriding commissions" constituted a change in accounting procedures as to the acceptance of which the Commissioner was said to have "wide discretion." 291 U. S., at 204. See the discussion in *Bressner Radio, Inc.*, v. *Commissioner*, 267 F. 2d 520, 525–526.

has been fully earned.[7] The underlying premise of the annual accounting requirement is that *otherwise reportable income* derived from a transaction cannot be excluded from gross income in order to let the taxpayer wait to see in a later year how the overall transaction turns out.[8] That is not the issue in this case. The question here is whether any reportable income has been derived from a transaction when payments are received in advance of performance.

Although wisely rejecting the claim of right and annual accounting arguments, the Court decides this case upon grounds which seem to me equally invalid. I can find nothing in *Automobile Club of Michigan* which controls disposition of this case. And the legislative history upon which the Court alternatively relies seems to me upon examination to be singularly unconvincing.

In *Michigan* there was no offer of proof to show the rate at which the taxpayer fulfilled its obligations under its membership contracts. The deferred reporting of prepaid dues was, therefore, rejected in that case simply because there was no showing of a correlation between the amounts

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[7] With the possible exception of contingent related expenditures, which cannot be accurately measured. See *Brown* v. *Helvering*, 291 U. S. 193, 200–201.

[8] This becomes entirely clear upon examination of the cases upon which the Government relies. For example, in *Heiner* v. *Mellon*, 304 U. S. 271, members of partnerships which had been formed to liquidate two corporations attempted to defer reporting income earned during the year until it could be determined in a subsequent year whether the partnerships' overall liquidation enterprise had been profitable. The Court held that such a postponement was barred by the annual accounting principle. In *Security Mills Co.* v. *Commissioner*, 321 U. S. 81, the taxpayer attempted to reopen a prior year's return so as to deduct amounts which it had subsequently paid out of receipts earned in that year. Again the Court relied on the annual accounting principle in denying the taxpayer's claim.

deferred and the costs incurred by the taxpayer in carrying out its obligations to its members. Until today, that case has been recognized as one that simply held that, in the absence of proof that the proration used by the taxpayer reasonably matched actual expenses with the earning of related revenue, the Commissioner was justified in rejecting the taxpayer's proration. I am hardly alone in thinking that *Michigan* was decided upon the very premise that a realistic deferral of income based upon proof of average costs of service during identifiable periods would be entirely permissible. See *Bressner Radio, Inc.*, v. *Commissioner*, 267 F. 2d 520, 526–529.[9] Such proof was concededly adduced in this case.

As to the enactment and repeal of § 452 and § 462, upon which the Court places so much reliance, there are, at the outset, obvious difficulties in relying on what happened in 1954 and 1955 to ascertain the meaning of § 41 of the 1939 Code. See *Fogarty* v. *United States*, 340 U. S. 8, 13–14; *Gemsco, Inc.*, v. *Walling*, 324 U. S. 244, 265; *Cammarano* v. *United States*, 358 U. S. 498, 510. But these problems aside, I think that the enactment and subsequent repeal of § 452 and § 462 give no indication of Congressional approval of the position taken by the Commissioner in this case. If anything, the legislative action leads to the contrary impression.

The statutory provisions in question were passed as part of a general revision of the internal revenue laws in 1954. Section 452 permitted an accrual basis taxpayer to defer the inclusion of advances in gross income until they were earned.[10] Most significantly, a taxpayer could shift to

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[9] See also Hoffman, Accounting Treatment Counts in Determining Net Taxable Income, 35 Taxes 918, 921; Behren, Prepaid Income-Accounting Concepts and The Tax Law, 15 Tax L. Rev. 343, 359–360; Note, 67 Yale L. J. 1425, 1439–1440.

[10] There were certain restrictions upon the period over which the advances could be deferred, but these are not relevant for our pur-

this method without the consent of the Cominissioner. Section 462, which permitted the deduction of anticipated expenses, was not aimed specifically at the problem of reporting advances.[11] The function of the provisions was to bring "[t]ax accounting . . . more nearly in line with accepted business accounting by allowing prepaid income to be taxed as it is earned rather than as it is received, and by allowing reserves to be established for known future expenses." [12]

In seeking to accomplish this objective, Congress recognized that as a result of "court decisions and rulings," the claim of right approach had been used to require reporting for the year of receipt all payments "subject to free and unrestricted use . . . even though the payments are for goods or services to be provided by the taxpayer at a future time." H. R. Rep. No. 1337, 83d Cong., 2d Sess.

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poses here. See Proposed Treas. Reg. §1.452, 20 Fed. Reg. 515; Wolder, Deduction of Reserves for Future Expenses and Deferring of Prepaid Income, 34 Taxes 524; Bierman and Helstein, Accounting for Prepaid Income and Estimated Expenses under the Internal Revenue Code of 1954, 10 Tax L. Rev. 83, 93–96. Section 452 specifically envisaged the deferral of club dues. See H. R. Rep. No. 1337, 83d Cong., 2d Sess. 48.

[11] See, *e. g.*, S. Rep. No. 372, 84th Cong., 1st Sess. 2. Section 462 provided that, "In computing taxable income for the taxable year, there shall be taken into account (in the discretion of the Secretary or his delegate) a reasonable addition to each reserve for estimated expenses . . . ." § 462 (a), 68A Stat. 158. "Estimated expense" was defined as a deduction "(A) part or all of which would . . . be required to be taken into account for a subsequent taxable year; (B) which is attributable to the income of the taxable year or prior taxable years for which an election under this section is in effect; and (C) which the Secretary or his delegate is satisfied can be estimated with reasonable accuracy." § 462 (d) (1), 68A Stat. 158. See Bierman and Helstein, Accounting For Prepaid Income and Estimated Expenses under the Internal Revenue Code of 1954, 10 Tax L. Rev. 83, 103–113.

[12] S. Rep. No. 372, 84th Cong., 1st Sess. 3 (quoting from the tax recommendation in the Presidential budget message of 1954).

48, A159.[13] Congressional awareness of administrative and judicial misapplication of the claim of right doctrine clearly did not imply approval of it. For by 1954, "[i]t was long recognized that the difficulty lay, not with the statute, but with administrative and court interpretation." [14] And while the Committee reports contain no express rejection of the Commissioner's interpretation of the 1939 statute, the language used in explaining the need for a change certainly indicates disapproval.[15]

Although § 452 and § 462 were short-lived, the shape of the decisional law with respect to § 41 of the 1939 Code changed considerably during the interval between the passage and repeal of the new sections. In *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697, the Tenth Circuit rejected the Commissioner's reliance on the claim of right rationale and found that the deferment of

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[13] There were some exceptions to the rigid application of this rule which had been recognized. See I. T. 3369, 1940–1 Cum. Bull. 46 (permitting deferred reporting of subscriptions for publishers who had consistently followed that practice); I. T. 2080, III–2 Cum. Bull. 48 (permitting deferment of receipts from sales of tickets for tourist cruises), but compare *National Airlines, Inc.*, 9 T. C. 159. See also *Veenstra & DeHaan Coal Co.*, 11 T. C. 964; *Summit Coal Co.*, 18 B. T. A. 983.

[14] Freeman, Tax Accrual Accounting for Contested Items, 56 Mich. L. Rev. 727, 729, n. 9. See Bierman and Helstein, Accounting for Prepaid Income and Estimated Expenses under the Internal Revenue Code of 1954, 10 Tax L. Rev. 83, 84.

[15] "Present law provides that the net income of a taxpayer shall be computed in accordance with the method of accounting regularly employed by the taxpayer, if such method clearly reflects the income and the regulations state that approved standard methods of accounting will ordinarily be regarded as clearly reflecting taxable income. Nevertheless, as a result of court decisions and rulings, there have developed many divergencies between the computation of income for tax purposes and income for business purposes as computed under generally accepted accounting principles . . . ." H. R. Rep. No. 1337, 83d Cong., 2d Sess. 48.

advances in accord with accrual principles did "clearly reflect . . . income" under § 41. At about the same time a Ninth Circuit decision permitted income received from the sale of goods to be offset by a deduction for the future expense of shipping the goods. *Pacific Grape Products Co.* v. *Commissioner*, 219 F. 2d 862.

When Congress repealed § 452 and § 462, the record shows that it was fully aware of these decisions. Congress recognized that the rationale of these cases would produce a complete reversal of the previous administrative position with respect to the reporting of unearned receipts under § 41 and its counterpart under the 1954 Code, § 446. Congressional intent with respect to this possibility was entirely clear—the trend of judicial decisions should be allowed to run its course *without any inference of disapproval being drawn from the repeal of § 452 and § 462.* This intent was evidenced in the assurances which the House Ways and Means Committee demanded and received from the Secretary of the Treasury, who had sought the repeal of the two sections. In a letter to the Chairman of the Committee, the Secretary stated:

> "My dear Mr. Chairman: This letter will confirm the statements made to you today by Treasury representatives.
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> . . . . . .
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> "Furthermore, the Treasury Department will not consider the repeal of section 452 as any indication of congressional intent as to the proper treatment of prepaid subscriptions *and other items of prepaid income, either under prior law or under other provisions of the 1954 code.* In other words, the repeal of section 452 will not be considered by the Department as either the acceptance or the rejection by Congress of the decision in *Beacon Publishing Co. v. Commis-*

sioner (218 F. (2d) 697, C. A. 10, 1955) or any other judicial decisions.

"It is my understanding *that the foregoing is consistent with the desire of your committee, with which I agree,* that the repeal of sections 452 and 462 should operate simply to reestablish the principles of law which would have been applicable if sections 452 and 462 had never been enacted." H. R. Rep. No. 293, 84th Cong., 1st Sess. 5. (Emphasis supplied.)

The same viewpoint was expressed in the Senate Report, which stated:

"Another aspect of the uncertainty with respect to subscription income if section 452 is repealed arises from a recent circuit court decision in *Beacon Publishing Company* v. *Commissioner* (C. C. A. 10th, January 3, 1955). The court in this case held that the deferral of prepaid subscription income was in fact proper under the accrual method of accounting. The Secretary of the Treasury in the letter previously referred to which he sent to the chairman of the House Committee on Ways and Means indicated that the repeal of section 452 would not be taken as an indication by the Treasury Department of congressional intent as to the proper treatment of prepaid subscription income under prior law or under other provisions of the 1954 code. He also indicated that the repeal of section 452 will not be considered by the Department as either acceptance or rejection by Congress of the decision in *Beacon Publishing Company* v. *Commissioner* or in any other judicial decisions. . . .

. . . . . .

"Uncertainty will also exist in other areas with the repeal of these two provisions. In *Pacific Grape Products* (C. C. A. 9th, February 10, 1955), for exam-

ple, the circuit court held that certain freight and shipping expenses incurred after the end of the year could be accrued for tax purposes as of the end of the year. An extension of the principles laid down in this case might well lead the courts in the future to permit the accrual of most estimated expenses which would be covered by section 462 even though this section is repealed." S. Rep. No. 372, 84th Cong., 1st Sess. 5–6.[16]

To my mind, this legislative history shows that Congress made every effort to dissuade the courts from doing exactly what the Court is doing in this case—drawing from the repeal of § 452 an inference of Congressional disapproval of deferred reporting of advances.[17] But even if the legislative history on this point were hazy, the same conclusion would have to be reached upon examination of Congressional purpose in repealing § 452 and § 462. Cf. *United States* v. *Benedict*, 338 U. S. 692, 696. For the fact of the matter is, contrary to the impression left by the Court's opinion, that the reasons for rejecting § 452 and § 462 were entirely consistent with accepting the deferred reporting of receipts in a case like this. Sections 452 and 462 were repealed *solely* because of a prospective loss of revenue during the first year in which taxpayers would take advantage of the new sections.[18]

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[16] See also H. R. Rep. No. 293, 84th Cong., 1st Sess. 4–5.

[17] It is to be noted that no such inference was relied upon in the *Michigan* case, although the same arguments with respect to §§ 452 and 462 were pressed upon the Court by the Government. See Brief for Respondent, pp. 62–65, *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180.

[18] See H. R. Rep. No. 293, 84th Cong., 1st Sess. 2–5; S. Rep. No. 372, 84th Cong., 1st Sess. 4–5; Hearings Before the Senate Finance Committee on H. R. 4725, 84th Cong., 1st Sess. 6. The prospective loss was more than ten times the original estimate of 47 million. *Ibid.* See Note, 67 Yale L. J. 1425, 1432, n. 25.

Insofar as the reporting of advances was concerned, that loss of revenue would have occurred solely as a consequence of taxpayers changing their method of reporting, without the necessity of securing the Commissioner's consent, to that authorized under § 452 and § 462.[19] The taxpayer who shifted his basis for reporting advances would have been allowed what was commonly termed a "double deduction" during the transitional year.[20] Under § 462, deductions could be taken in the year of change for expenses attributable to advances taxed in prior years under a claim of right theory, as well as for reserves for future expenditures attributable to advances received and reported during that year. Similarly, under § 452, prepayments received during the year of transition would be excluded from gross income while current expenditures attributable to past income would still be deductible.[21]

The Congressional purpose in repealing § 452 and § 462—maintenance of the revenues—does not, however, require disapproval of sound accounting principles in cases of taxpayers who, like the petitioner, have custo-

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[19] There was also a problem of expanded use of reserves for estimated expenditures under § 462 for items like vacation pay which were not related to the reporting of advances. See Hearings Before the Senate Finance Committee on H. R. 4725, 84th Cong., 1st Sess. 5, 9; Sporrer, The Past and Future of Deferring Income and Reserving for Expenses, 34 Taxes 45, 55–56; Griswold, Federal Taxation (5th ed. 1960), 497–498.

[20] See S. Rep. No. 372, 84th Cong., 1st Sess. 4; Hearings Before the Senate Finance Committee on H. R. 4725, 84th Cong., 1st Sess., at 7, 8, 10; Dakin, The Change from Cash to Accrual Accounting for Federal Income Tax Purposes—Pyramided Income, Double Deductions and Double Talk, 51 Nw. U. L. Rev. 515, 530–538; Griswold Federal Taxation (5th ed. 1960), 497–498; Note, 67 Yale L. J. 1424, 1430.

[21] Only one-tenth of the estimated loss during the transitional year was attributable to § 452. See Hearings Before the Senate Finance Committee on H. R. 4725, 84th Cong., 1st Sess. 21.

marily and regularly used a sound accrual accounting method in reporting advance payments. No transition is involved, and no "double deduction" is possible. Moreover, taxpayers formerly reporting advances as income in the year of receipt can now shift to a true accrual system of reporting only with the approval of the Commissioner. See Treas. Reg. 111, § 29.41–2 (1942); Treas. Reg. 118, § 39.41–2 (c) (1953); Int. Rev. Code of 1954, § 446 (e).[22] Before giving his approval the Commissioner can be expected to insist upon adjustments in the taxpayer's transition year to forestall any revenue loss which would otherwise result from the change in accounting method. See *Kahuku Plantation Co.* v. *Commissioner*, 132 F. 2d 671, 674; 2 Mertens, Law of Federal Income Taxation, §§ 12.21, 12.21a. Cf. *Brown* v. *Helvering*, 291 U. S. 193, 204.

In short, even if the legislative history of the repeal of § 452 and §462 did not clearly indicate, as it does, that the repeal of those sections should have no bearing upon judicial determination of whether the deferred reporting of advances "clearly reflects income," the purpose of the Congress which repealed those provisions would lead to the same conclusion. It need hardly be added that the subsequent legislative activity cited by the Court in no way alters this conclusion. Contrary to the Court's suggestion, the "relief that the Association seeks in this Court" is far short of what was sought in 1958 in urging that the coverage of § 455 be extended to prepaid automobile club membership dues. As enacted, § 455 was not limited in application to publishers previously reporting prepaid subscriptions on a deferral basis. See I. T. 3369, 1940–1 Cum. Bull. 46. It applied to all publishers using the accrual method and permitted a change

[22] See also Treas. Reg. § 1.446–1 (e) (2) (1957); *Brown* v. *Helvering*, 291 U. S. 193, 204–205; *Advertisers Exchange, Inc.*, 25 T. C. 1086, 2 Mertens, Law of Federal Income Taxation, § 12.19–12.20.

to deferred reporting of subscriptions for the year 1958 *without consent* of the Commissioner. 26 U. S. C. § 455 (c)(3)(B).

II.

I think the Government's position in this case is at odds with the statutes,[23] regulations,[24] and court decisions,[25] which, since 1916, have recognized that realistic accrual

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[23] The Revenue Act of 1913, 38 Stat. 114, provided only for a strict cash receipts and disbursements method of accounting. See *e. g.*, § 2 (b), 38 Stat. 167. In the 1916 Act, the sections dealing with permissible methods of computing income were revised to provide that:

"A corporation . . . keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, . . ." § 13 (d), 39 Stat. 771. See also § 8 (g), 39 Stat. 763 (identical provision with respect to returns filed by individuals).

These sections were designed specifically to permit accrual accounting. See H. R. Rep. No. 922, 64th Cong., 1st Sess. 4; *United States* v. *Anderson*, 269 U. S. 422, 439–441. In the Revenue Act of 1918, the necessity of obtaining special permission to use the accrual method was omitted, see § 212 (b), 40 Stat. 1064–1065, and the provision permitting the use of accrual accounting remained substantially the same for the next thirty-six years. See Int. Rev. Code of 1939, § 41, 53 Stat. 24; Henry Reubel, 1 B. T. A. 676, 677–678. In 1954 the pertinent provision was again changed, with specific mention of the "accrual method." See Int. Rev. Code of 1954, § 446, 26 U. S. C. § 446. See generally, May, Accounting and the Accountant in the Administration of Income Taxation, 47 Col. L. Rev. 377, 380–382.

[24] See, *e. g.*, T. D. 2433, 19 Treas. Dec. 5 (1917); Treas. Reg. 45, § 212, Art. 23; § 214, Art. 111 (1920); Treas. Reg. 118, § 39.41 (1953); Treas. Reg. § 1.446–1 (1957).

[25] See, *e. g.*, *United States* v. *Anderson*, 269 U. S. 422; *Niles Bement Pond Co.* v. *United States*, 281 U. S. 357; *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 92; *Spring City Co.* v. *Commissioner*, 292 U. S. 182, 184–185; see also *Weed & Brothers* v. *Commissioner*, 38 F. 2d 935, 938–940.

accounting does "clearly reflect income." If I am correct, the law did not give the Commissioner any "discretion . . . not to accept the taxpayer's accounting system."

The basic concept of including advances in gross income only as they are earned is but an aspect of accrual accounting principles which have consistently received judicial approval. We have, for example, often recognized that deductions for business expenses must be reported as soon as the obligation to pay becomes "certain." See, *e. g.*, *United States* v. *Anderson*, 269 U. S. 422; *American National Co.* v. *United States*, 274 U. S. 99; *Niles Bement Pond Co.* v. *United States*, 281 U. S. 357, 360; *United States* v. *Olympic Radio and Television*, 349 U. S. 232, 236. This may be before or after cash payment is made,[26] or even before it is due.[27] The controlling factor is not the flow of cash, but the "economic and bookkeeping" principles with which § 41 is concerned. *United States* v. *Anderson*, *supra*, at 441. See also *American National Co.* v. *United States*, *supra*. These principles are at the foundation of the so-called "all events" test for determining the accrual of deductions. See *United States* v. *Anderson*, *supra*, at 441; [28] *United States* v. *Consoli-*

[26] Compare, *e. g.*, *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 94 (deduction taken in year prior to cash disbursement) with *Shelby Salesbook Co.* v. *United States*, 104 F. Supp. 237 (deduction taken in later year).

[27] *United States* v. *Anderson*, 269 U. S. 422; *American National Co.* v. *United States*, 274 U. S. 99; *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 92.

[28] The Court there held that an accrual taxpayer should have deducted a tax expense in 1916 so that it properly could have been offset against the profits from sales in 1916 upon which the tax was levied. The Court rejected the contention that the tax could not accrue in 1916 because it was not due until 1917. It stated:

"In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of

dated Edison Co., — U. S. —, —. The same principles are applicable to the accrual of income. See *Continental Tie & L. Co.* v. *United States*, 286 U. S. 290. As has been correctly noted, "[i]t is a necessary corollary of this 'economic and bookkeeping' proposition" upon which *Anderson* rested that receipts are not reportable in income until "substantially 'all the events' have occurred, both as to the cost and time of performance, which must occur in order to discharge the liability to perform which was given by [the taxpayer] in return for the receipt." *Bressner Radio, Inc.*, v. *Commissioner*, 267 F. 2d 520, 524. See also *United States* v. *Anderson*, *supra*, at 440; *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697, 699. Indeed, "accrual" of income has been commonly defined in terms of "earnings" from the sale of goods or the performance of services. See, *e. g.*, *Spring City Co.* v. *Commissioner*, 292 U. S. 182, 184–185; Stanley and Kilcullen, The Federal Income Tax (3d ed. 1955), 190.[29] In reject-

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the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued. It should be noted that § 13 (d) makes no use of the words 'accrue' or 'accrual' but merely provides for a return upon the basis upon which the taxpayer's accounts are kept, if it reflects income—which is precisely the return insisted upon by the Government." 269 U. S., at 441.

[29] The authors there state:

"In the ordinary case, accrual precedes actual receipt since there is an accrual when there is a *right* to receive. But in some cases items are received before they are earned, and then the receipt precedes the accrual."

See also *Continental Tie & L. Co.* v. *United States*, 286 U. S. 290; *Georgia School-Book Depository, Inc.*, 1 T. C. 463; 1961 C. C. H. Tax Reporter § 2820.025 ("On the accrual basis, income is reported when earned"); Freeman, Tax Accrual Accounting for Contested Items, 56 Mich. L. Rev. 727, 728.

ing petitioner's method of allocating prepaid advances, the Court, I think, disregards these basic principles.

The net effect of compelling the petitioner to include all dues in gross income in the year received is to force the petitioner to utilize a hybrid accounting method—a cash basis for dues and an accrual basis for all other items. *Schlude* v. *Commissioner*, 283 F. 2d 234, 239. Cf. *Commissioner* v. *South Texas Co.*, 333 U. S. 496, 501. For taxpayers generally the enforcement of such a hybrid accounting method may result in a gross distortion of actual income, particularly in the first and last years of doing business. On the return for the first year in which advances are received, a taxpayer will have to report an unrealistically high net income, since he will have to include unearned receipts, without any offsetting deductions for the future cost of earning those receipts. On subsequent tax returns, each year's unearned prepayments will be partially offset by the deduction of current expenses attributable to prepayments taxed in prior years. Even then, however, if the taxpayer is forbidden to correlate earnings with related expenditures, the result will be a distortion of normal fluctuations in the taxpayer's net income. For example, in a year when there are low current expenditures because of fewer advances received in the preceding year, the result may be an inflated adjusted gross income for the current year. Finally, should the taxpayer decide to go out of business upon fulfillment of the contractual obligations already undertaken, in the final year there will be no advances to report and many costs attributable to advances received in prior years. The result will be a grossly unrealistic reportable net loss.

The Court suggests that the application of sound accrual principles cannot be accepted here because deferment is based on an estimated rate of earnings, and because this estimate, in turn, is based on average, not

individual, costs. It is true, of course, that the petitioner cannot know what service an individual member will require or when he will demand it. Accordingly, in determining the portion of its outstanding contractual obligations which have been discharged during a particular period (and hence the portion of receipts earned during that period), the petitioner can only compare the total expenditures for that period against estimated average expenditures for the same number of members over a full contract term. But this use of estimates and averages is in no way inconsistent with long-accepted accounting practices in reflecting and reporting income.

As the Government has pointed out in past litigation, "many business concerns . . . keep accounts on an accrual basis and have to estimate for the tax year the amount to be received on transactions undoubtedly allocable to such year." *Continental Tie & L. Co.* v. *United States*, 286 U. S. 290, 295–296. Similarly, the deduction of future expenditures which have already accrued often requires estimates like those involved here. See, *e. g.*, *Harrold v. Commissioner*, 192 F. 2d 1002; *Schuessler* v. *Commissioner*, 230 F. 2d 722; *Denise Coal Co.* v. *Commissioner*, 271 F. 2d 930, 934–937; *Hilinski* v. *Commissioner*, 237 F. 2d 703. Finally, it is to be noted that the regulations under both the 1939 and 1954 Codes permit various methods of reporting income which require the use of estimates.[30] In the absence of any showing that the

[30] See, *e. g.*, Treas. Reg. 111, § 29.42-4 (1942), Treas. Reg. 118, § 39.42-4 (1953), and Treas. Reg. § 1.451-3 (1957) (providing for the percentage of completion method of reporting income on long-term contracts); Treas. Reg. 111, § 29.42-5 (1942), Treas. Reg. 118, § 39.42-5 (1953), and Treas. Reg. § 1.451-4 (1957) (providing for the deduction for redemption of trading stamps based upon "the rate, in percentage, which the stamps redeemed in each year bear to the total stamps issued in such year"). See generally *Brown & Williamson Tobacco Corp.*, 16 T. C. 432.

estimates used here were faulty, I think the law did not permit the Commissioner to forbid the use of standard accrual methods simply upon the ground that estimates were necessary to determine what the rate of deferral should be.

Similarly, it is not relevant that the petitioner "defers receipt . . . of dues to a taxable period in which, no, some, or all the services paid for by those dues may or may not be rendered." The fact of the matter is that what the petitioner has an obligation to provide, *i. e.*, the constant readiness of services if needed, will with certainty be provided during the period to which deferment has been made. Averages are frequently utilized in tax reporting. In computing the value of work in process, in distributing overhead to product cost, and in various other areas, the use of averages has long been accepted. See, *e. g.*, *Rookwood Pottery Co.* v. *Commissioner*, 45 F. 2d 43; *Eatonville Lumber Co.*, 10 B. T. A. 232. The use of an "average cost" is particularly appropriate here where the dues are earned by making services continuously available. The cost of doing so must necessarily be based on composite figures.

For these reasons I think that the petitioner's original returns clearly reflected its income, that the Commissioner was therefore without authority under the law to override the petitioner's accounting method, and that the judgment should be reversed.